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INQUIRY

on

WHOLESALE AND RETAIL PRICING PRACTICES

for

FLUID MILK

in

ONTARIO 1971 TO 1975



THE MILK COMMISSION OF ONTARIO



**Ministry of
Agriculture
and Food**

R.G. Bennett
Deputy Minister

Hon. William G. Newman
Minister



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THE MILK COMMISSION OF ONTARIO

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Toronto

February 1977



Ontario

Ministry of
Agriculture
and Food
The Milk Commission of Ontario

416/965- 3107

Parliament Buildings
Queen's Park
Toronto Ontario
M7A 2B2

February 8, 1977.

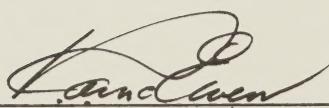
The Honourable William G. Newman,
Minister of Agriculture and Food,
Parliament Buildings,
Queen's Park,
Toronto, Ontario.
M7A 1A3

Dear Mr. Minister:

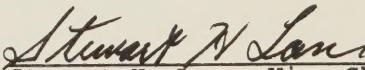
Pursuant to the provisions of section 4 (2) c. of The Milk Act, Revised Statutes of Ontario, 1970, and amendments thereto, the Commission instituted a study concerning, amongst other matters, the pricing practices and margins between processors, distributors and retailers of fluid milk products.

The Commission has completed its work in this connection and now submits its Report.

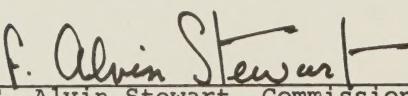
Signed



K.A. McEwen, Chairman



Stewart H. Lane, Vice-Chairman



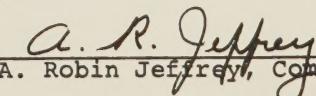
F. Alvin Stewart, Commissioner



J.R. Anstis, Commissioner



W.J. Knapp, Commissioner



A. Robin Jeffrey, Commissioner

TERMS OF REFERENCE

The Terms of Reference are:

1. To investigate pricing practices and margins between processors, distributors and retailers of fluid milk products.
2. To inquire into the manner in which these practices may vary within a corporate organization.
3. To examine the manner in which these practices may vary from one part of the Province to another.
4. To inquire into the variations in practices between different processors, distributors and retailers within the Province.
5. To investigate the retail margins currently being given on the basis outlined in numbers 2, 3 and 4.
6. To inquire into discount practices in and after the year 1972.
7. To compare the retail margins and discount practices in Ontario with those in other jurisdictions.

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BACKGROUND OF THE INQUIRY

On Wednesday, March 26, 1975, the then Minister of Agriculture and Food, the Honourable William A. Stewart, announced that The Milk Commission of Ontario would conduct an Inquiry concerning the fluid milk industry within Ontario in accordance with the Terms of Reference set out in this Report.

As a result, during May and June of 1975, requests for written or oral briefs were advertised in the daily and weekly newspapers throughout Ontario. The Commission announced that a series of public hearings would be held for the purpose of receiving and discussing the briefs submitted.

During the summer public hearings were conducted by the Commission in Sault Ste. Marie, London, Kingston and Toronto, during which some 45 briefs were received from processors, retailers, distributors, consumer groups, labor unions, The Ontario Milk Marketing Board and other interested citizens. These briefs, and the attendant discussions concerning them, have been studied by the Commission. The briefs and the recorded discussions are now on file in the offices of the Commission.

The Commission is very grateful to those individuals and organizations who made oral presentations or submitted briefs at the public hearings. A list of those submitting briefs is given in Exhibit 2.

In addition to but before the public hearings, the Commission retained the services of W.R. Poole, Q.C. of London to act as Legal Counsel to the Commission and of Price Waterhouse & Co. of Toronto, chartered accountants, to act as Financial Counsel.

A set of questionnaires was prepared and circulated to 151 retailers, 63 non-processor-distributors, 43 processors and 30 head offices each directly involved in the fluid milk

industry within Ontario. The purpose of the questionnaire was to furnish the Commission with an accurate financial and statistical background of the practices of the various firms involved in the processing, distributing and retailing of fluid milk within Ontario. An analysis of the information gathered from the questionnaires appears in Part B of the Report.

The Commission gratefully acknowledges the considerable time and effort spent by the individuals who completed the questionnaires. The information supplied by them provided the basic data required to respond to questions raised in the Terms of Reference of the Inquiry.

In addition to its investigations within Ontario, the Commission made a comparative study of milk pricing in each of the provinces in Canada, excluding Newfoundland. The results of these comparisons are included in Part C of this Report.

This Report was drafted by Professor Stewart H. Lane of the School of Agricultural Economics and Extension Education, University of Guelph. We wish to express our appreciation to the University of Guelph for making Professor Lane available for this task.

The Commission gratefully acknowledges the assistance of its staff in the various phases of this Inquiry. Dr. Marvin Sundstrom, formerly Director of Research and Policy Development for the Commission, summarized the information presented at the public hearings and drafted various working papers for the Commission. In January 1976 he joined the faculty of the University of Lethbridge but maintained an active interest in the Inquiry until it was completed.

We are also especially indebted to Mr. Albert Nyholt of the Commission staff for his work in guiding the collection of the data on which most of the financial analysis in this Report is based.

PRINCIPLES GUIDING THE INQUIRY

During the course of this Inquiry the Commission adopted certain guiding principles which it felt were necessary to provide fair and equitable treatment to all parties involved in the Inquiry and to the issues raised in the Terms of Reference.

1. That every effort would be made to inform the public throughout the Province, as well as various sectors of the industry, about the Inquiry.
2. That all groups and individuals who wished to be heard would be given an opportunity to be heard whether they had submitted a written brief or wished to present submissions orally.
3. That the location of public hearings would be dependent on the response from both the public and the industry.
4. That every effort would be made to have all sides of the issue presented. This called for presentations from producers, processors, distributors and retailers, as well as consumers.
5. That the Commission was on a fact finding mission and was resolved to treat each sector of the industry with candour and openness and without prejudice.

SUMMARY AND CONCLUSIONS

Throughout 1973 and 1974 the retail price of fluid milk increased substantially following a period of relative price stability. Although the effect of inflation on prices was widespread during this period, it was particularly evident in food prices. Increases in food prices and especially milk have always been a sensitive public issue; thus it was not surprising that there was mounting public concern regarding the justification for these rapid increases.

The pricing system for fluid milk in Ontario provides for a review of price increases at the producer level. Any such price increases proposed by The Ontario Milk Marketing Board on behalf of the producers can be appealed before The Milk Commission of Ontario by anyone who feels aggrieved by that action. The legislation in Ontario governing the marketing of fluid milk makes no such provision for a review of the prices established for fluid milk at subsequent stages in the marketing system.

Accordingly, in March 1975, the Minister of Agriculture and Food in Ontario announced that the Milk Commission would undertake a Public Inquiry into milk pricing at the processor, distributor and retail levels. Under the Terms of Reference established for the Inquiry, the Commission was asked to investigate the pricing practices and margins for fluid milk products between processors, distributors and retailers, to examine how these practices and margins varied from region to region and firm to firm within the Province and to compare the practices prevalent in Ontario with those in other jurisdictions. The Commission also was asked to investigate discount practices between processors, distributors and retailers in and after the year 1972.

During the summer of 1975 the Commission held public hearings throughout the province and received written briefs and oral presentations. Concurrently, the services of Price Waterhouse & Co. were retained as Financial Counsel to the Inquiry. They were to collect, analyze and report on the information required to determine the average levels of, and trends in, the prices, margins and discount practices of a representative sample of Ontario firms engaged in processing, distributing and retailing fluid milk. Since the central issue of this Inquiry was to determine whether the margins being realized by these firms were or were not excessive, it was also necessary to collect financial data on the costs and profits of these firms.

For these purposes, a sample was established which included all the large processors and retail chain stores in Ontario as well as a number of the smaller processors, distributors and independent retail outlets. Each firm included in the sample was asked to provide the necessary data regarding its costs, prices, discounts and profits for the period December 1971 to June 1975. In addition, supplementary information concerning pricing and discount practices was obtained from the corporate head offices of the large processing and retail firms.

Through correspondence and personal interviews the Commission also collected information on the pricing systems, discount practices and price levels which were in effect for fluid milk in other provinces.

The costing and pricing of milk as it moves through the marketing system in Ontario is a very complex process. The cost of raw milk to the fluid processor varies according to the products into which the milk is manufactured and according to whether the processors'

fluid sales are made in Southern or Northern Ontario. While the bulk of the milk purchased by fluid milk processors will be processed into homo, 2% and skim milk, the proportion of their total milk purchases that is used for this purpose will vary from plant to plant.

Similarly, the markets served by fluid milk processors and hence their selling prices will vary greatly from plant to plant. Some smaller processors may derive a significant proportion of their sales from servicing home delivery customers and small retail outlets, others may service franchised convenience stores, while yet others may deal primarily with large retail chain stores.

Consumers are purchasing an ever increasing share of their fluid milk requirements from stores as opposed to home delivery. An increasing proportion of store sales are being made by large retail outlets which are supplied directly by the processors. These trends, coupled with the "best before" date on milk packages, have resulted in a marked increase in store returns to the processors. This development represents a substantial increased cost to the processors which ultimately will be borne by the consumers unless effective procedures are introduced to control it.

Milk distributors also vary in size and clientele. Most milk distributors also carry other food products to help defray their operating costs.

Retail outlets which sell fluid milk carry a wide range of inventory items. In general, the greater the number of different items a retail outlet sells, the more difficult it is to determine the costs of retailing a specific item. The pricing policies and discounts

received by some retail stores are dictated largely by their corporate head offices while others are free to establish their own pricing policies.

Add to these major structural differences between firms at each level of the industry the regional variations ranging from the large compact market in Metropolitan Toronto to the sparse, relatively small markets in Northern Ontario, and it is readily apparent that the processing and distributing of fluid milk is a very heterogeneous industry which cannot be described in a meaningful way by simple averages.

The problem of evaluating prices and margins on fluid milk is further complicated by the fact that the various firms within the industry do not use uniform accounting procedures. Thus, it is impossible to establish and compare the costs of processing, distributing or retailing fluid milk by the various firms on a uniform historical basis. To add to the complexity of the problem, those firms which carry other merchandise in addition to fluid milk, such as distributors and food retail stores, do not record separately the costs associated with handling fluid milk.

Bearing in mind the fundamental weaknesses in the basic data available to the Commission, it has drawn several conclusions regarding the matters posed in the Terms of Reference. Wherever possible, the Commission has compared its findings with those of other agencies. However, the reader is cautioned against attaching a high degree of precision to the figures quoted in this Report. Where the data indicate a substantial difference, for example on margins on different types of milk or package sizes, the reader may assume with some confidence that a difference did exist but that the actual magnitude of the difference could be greater or smaller than that indicated. Small differences are probably not significant.

Perhaps the most important conclusion to be drawn from this investigation is that processors, distributors and especially retailers do not establish their selling prices for fluid milk based solely on their costs of operation. If this were the case, the selling prices for fluid milk at the various stages through the marketing system would vary in proportion to changes in the product cost and in the operating costs at each level. The results of this analysis indicate that this is not the case. Rather, it is apparent that while processors, distributors and retailers take cost changes into account in establishing their selling prices, they also consider the competitive climate in the market they serve and attempt to strike a price which will enable them to retain or increase their share of the market. That price may be higher or lower than that required to enable them to maintain the same relationship between price and cost as prevailed before the change occurred in prices and costs. The recent price war on milk in three quart containers when prices less than one dollar were common in some markets is clear evidence of factors other than cost having a major influence on pricing decisions.

This same principle can be used to explain the relative prices of homo, 2% and skim milk. If cost were the only factor to be considered, the prices of these three types of milk would reflect their relative fat content since there are no other major differences in the cost of processing, distributing or retailing these three types of fluid milk. Although in general the price of skim milk is cheaper than 2% and 2% is cheaper than homo, this pattern is by no means uniform in the various markets throughout the Province and in some instances the reverse occurs. Furthermore, if the prices were based solely on differences in the fat content, one would expect the relative difference in the prices of these milks to be much greater. One of the reasons for the relatively high

price for skim milk would appear to be its small share of the fluid milk market. Without more evidence of consumer acceptance of this product, both processors and retailers have little incentive to lower the price on this product.

If these conclusions are valid they underline the key role which the consumer plays in the market for fluid milk. Our findings suggest that retailers are responsive to market demand and that competition between suppliers is relatively keen in most Ontario fluid milk markets. As long as these conditions exist consumers, through judicious buying on their part, can assure themselves of their fluid milk requirements at prices that are reasonable in relation to the cost of the product and the marketing services provided with it.

From December 1971 to June 1975 the average retail selling price of fluid milk increased more than the average processor selling price. In effect, the retailers' average margin on milk purchased directly from processors more than doubled. Retailers who purchased their milk supplies through distributors experienced much smaller increases in their margins because, in their case, the distributors received an increasing share of the total marketing spread between the processors' product cost and retailers' selling prices. However, most of the milk sold through retail outlets (over 80 percent) is purchased directly from processors.

In Southern Ontario the average retail margin on fluid milk bought directly from processors increased by over 70 percent from December 1973 to December 1974. During this same period the purchase cost of the product to the retailer increased by 29 percent and the retail price increased by 33 percent. Although inflation was proceeding at a rapid rate during this period we found no evidence to suggest that retailers' costs were increasing as rapidly as their margins increased. The Consumer Price Index increased by about 13 percent during these 12 months.

These simple percentage comparisons of costs and prices can be misleading by exaggerating the effect which a relatively large percentage increase in margin would have on retail price. For example, if the retail margin had increased by 30 percent instead of 70 percent it would have meant a reduction in average retail selling price per quart of fluid milk of only 1.4 cents. Although the profits of milk processors, distributors and food retailers increased from 1971 to 1974 we found no evidence to indicate that the profits they realized were excessive. These profits refer to the profitability of the total business of these firms and not just to the fluid milk portion of their operations. In the case of retailers in particular, fluid milk represents a relatively small proportion of their total sales and hence these overall profit ratios are not a reliable indicator of whether fluid milk was making a reasonable contribution to the profits of the business.

Fluctuations in profits from year to year are a normal expectation in business and the profits earned by these firms during this period were not high in relation to the historical pattern for their respective types of business. There was also evidence of considerable variation in profitability from firm to firm indicating that keen competition throughout the industry dominates management decisions with respect to pricing and operational efficiency.

Fluid milk prices, product cost and margins tended to be higher at both the processor and retail level in Northern Ontario as compared with the larger more densely populated market in Southern Ontario. This is the relationship one would expect, given the higher costs of operating in Northern Ontario.

A comparison of the retail margins in various markets throughout the Province revealed considerable

variation from market to market. While in general retail margins increased from 1971 to 1975, some markets (e.g. Oshawa, Thunder Bay and Kirkland Lake) retained very narrow margins throughout the period. Other markets (e.g. Ottawa) experienced a substantial increase while several others had only modest increases. Still others maintained relatively large margins throughout the period (e.g. Kitchener-Waterloo and Distribution Area 1 excluding Windsor). There was no apparent relationship between the size of the retail margin in an area and its geographical location or the size and density of the market. This would suggest there are variations in the extent of competition in the various markets for fluid milk throughout the Province.

Of particular interest was the uniformity of average retail selling prices of fluid milk in Distribution Area 4 which includes the cities of Toronto, Oshawa and Hamilton and the adjacent Distribution Areas 5 and 7. This region contains a major proportion of the fluid milk processing capacity and retail outlets in the Province. Obviously, competition for sales at the retail level has largely eliminated significant differences between retail outlets in the retail prices of fluid milk. However, there was not a similar uniformity of retail margins throughout the various markets in these three Distribution Areas as evidenced by the considerable variability in prices paid by retailers for their fluid milk supplies. There were significant differences in the relative bargaining strength of the individual retailers which enabled them to purchase their requirements from processors and distributors at different prices.

The price a retailer pays for his milk supplies is directly related to his ability to bargain with his supplier for a discount from the supplier's list price. Discounts are a common business practice. Most fluid milk

processors and distributors have two or more list prices from which they offer discounts of varying types and amounts depending upon such factors as type and size of account, type of marketing services provided and geographical location. Most retail stores receive a volume discount based on the quantity of fluid milk products purchased. Additional discounts may be offered for prompt payment and special promotions. Supplementary discounts are frequently negotiated between large multi-market processors and the head offices of the large retail chains.

Although the amount of discount received may increase or decrease from one period to the next, these changes have little significance by themselves since their real effect depends upon how they vary in relation to list prices. Thus, in terms of margins it is the difference between the list price and the discount, i.e. the net price, that is significant.

Although the amount of discount per quart offered by both processors and distributors increased during the period covered by this Inquiry, list prices also increased, but by a smaller amount, thus offsetting part of the benefit of increased discounts to the purchaser. Some of the trend toward increased discounts can probably be attributed to structural changes in the fluid milk marketing system. This has had the effect of reducing the cost of the marketing services which the processor-distributor was providing. For example, the costs incurred by a processor in servicing a large retail chain account where a large order is merely delivered to a dock are much less than those involved in servicing a large number of small retail outlets and home delivery customers. An increasing proportion of fluid milk is being merchandised through the former channel.

Thus, in brief, the practice of offering discounts is not a new development nor is it one that is peculiar to the fluid milk industry. It is a competitive tool in common use by both processors and distributors to capture a larger share of the fluid milk market. The large retailers are in a much stronger position to command large discounts from their suppliers than smaller accounts. Whether the benefits of these discounts are passed on by the retailers to their customers will depend on the competitive pressures they face in their respective markets.

The data made available to this Inquiry by the survey respondents indicated that there was little difference between the average retail selling price of fluid milk in the large retail chains and the smaller retail outlets. Furthermore, the average margins of the retailers expressed as a percentage of their average selling price increased between 1971 and 1975 whereas they declined for the processors. This would indicate that the large retailers were able to retain most of the benefit they gained from receiving greater discounts from their suppliers and were not forced through competition to pass these on to consumers.

As indicated previously, retailers were able to realize much larger margins on fluid milk in 1974 and 1975 than they did in the three previous years. The increases in retail margins on fluid milk which occurred during this period appear to be greater than the increases in operating costs associated with retailing fluid milk. It would appear that if the average retail price of milk in 1974 and 1975 had been about 1.0 to 2 cents per quart lower, the retailers would still have realized adequate margins on fluid milk.

For several months during 1976 a price war on

fluid milk has been in effect in several major Ontario markets. Detailed investigation of this phenomenon is beyond the scope of this Inquiry. It would appear that in some cases the retail selling price is below the processors net selling price. While it is not suggested that this price war was initiated as a result of any collusion by retailers, it is conceivable that milk retailers would argue that any excess margins they may have earned in 1974-5 have been offset by these relatively cheap prices in 1976. Even though this may be true it is not a justification for unreasonably high margins at any time. Unduly high prices for fluid milk in any period are likely to have continuing depressing effects on the subsequent demand for the product. Once consumers have been dissuaded from purchasing fluid milk because of unrealistically high prices it is unlikely that they will return to their normal consumption habits, even with the enticement of temporary abnormally low prices at a later date.

The extent to which fluid milk prices are regulated and controlled varies considerably from province to province. In Ontario, the Milk Marketing Board has been granted legislative authority to determine the price at which raw milk is sold to processors. However, any price established by the Board is subject to appeal to the Milk Commission by any person or group who feels aggrieved by that decision and the Commission may overrule the Board's decision. Fluid milk prices at the wholesale and retail level are not subject to any government control in Ontario.

A somewhat greater degree of control is exercised in British Columbia in that monthly adjustments in the producer price are made based on a formula. Retail sales below cost are prohibited. The British Columbia Milk

Control Board has established a schedule for volume discounts based on type of store service, frequency of store drops and value of sales.

In the Prairie Provinces producer prices are set based on cost of production. Minimum retail and wholesale prices are set in Alberta with no differential between store and home delivery prices. In Saskatchewan the minimum retail and wholesale prices are set, while in Manitoba the maximum retail price is set for store sales. Volume discounting is prohibited in Alberta and Saskatchewan, but not in Manitoba.

In Quebec the Agricultural Marketing Board sets minimum producer prices and minimum and maximum wholesale and retail prices for fluid milk. In the Maritime Provinces prices are controlled at the producer, wholesale and retail levels.

A more detailed investigation beyond the scope of this Inquiry would be required to determine the effect which these price control procedures have had on fluid milk prices at the wholesale and retail level in the different provinces.

Investigation of fluid milk prices in seven major Canadian cities by the Food Prices Review Board revealed that while the average retail price in Toronto during the period 1972-74 was relatively low, the processor margin in Toronto was considerably lower and the retail margin substantially higher than in the other cities. However, the total farm-retail price spread in Toronto (14.9 cents) was slightly lower than the average spread for the seven cities (15.0 cents). Only Winnipeg (13.7 cents) and Montreal (14.2 cents) reported lower figures. Thus, higher marketing margins existed in four other cities, each of which was subject to a greater degree of government control of fluid milk margins than Toronto. However, each market is different in terms of cost of inputs, size and density of market and methods of distribution. Thus, differences

in marketing margins cannot be attributed solely to the presence or absence of price controls.

The data collected by The Milk Commission of Ontario on prices and margins in the different provinces from mid September to mid October 1975 were based on the price of homo milk in one quart paper containers. These data relate to a different time period than that examined by the Food Prices Review Board and are more specific with regard to type of milk and size of package. Thus, they are not directly comparable to the data collected by the Board. They do not necessarily reflect the relative margins and prices of total fluid milk sales in the various provinces. However, they do indicate findings similar to those of the Board in that the average processor margin in Ontario was among the lowest compared to other provinces while the retail margin was exceptionally large, resulting in a relatively high retail price.

Nevertheless, the existence of a large retail margin is not by itself sufficient justification for imposing wholesale and retail price controls. For price controls to be justified, they should provide a net benefit to the public (i.e. producers and consumers) and be the least costly means of achieving that benefit. Viewed in this light the experience gained with price controls on fluid milk in various jurisdictions both in Canada and the United States would seem to indicate that such controls do not necessarily result in lower margins and prices. Rather, they tend to retard innovations which lead to a more efficient processing and distribution system. In addition, they are costly to administer and enforce especially in regions such as Ontario where many different types of fluid milk are marketed in a wide variety of packages through different distribution systems.

Nevertheless, the public is entitled to some protection, since one cannot assume that there will always be

sufficient competition throughout the marketing system to ensure that margins and prices do not reach excessive levels. To protect the public interest in this regard a continuous monitoring of wholesale and retail prices and margins on fluid milk should be carried out with the intent of identifying the existence and causes of any extraordinary and unjustifiable excesses. Where such excesses are discovered, appropriate steps should be taken to give them wide publicity. This approach is likely to be as effective as legislated price controls. It will also be less costly to the public treasury.

PRINCIPAL RECOMMENDATIONS

1. We believe that in general the marketing system for fluid milk is relatively efficient, progressive, flexible and equitable. Based on this Inquiry into the Ontario fluid milk industry, the imposition of wholesale and/or retail price controls on fluid milk is not justified at this time. We believe that most Ontario fluid milk consumers have considerable choice with respect to the type of milk they purchase and the supplier from whom they purchase it. Provided they make their choices wisely, consumers should be able to obtain milk at reasonable prices, whether it be homo, 2% or skim. However, from time to time in certain markets there may be a lack of effective competition which results in consumer prices being higher than necessary.
2. We believe it is imperative that there be a continuing assessment of the effect of changes taking place in the structure of the processing, distributing and retailing sectors of the fluid milk industry and on its competitive performance and that appropriate action be taken to correct any harmful practices which are found to exist.

To achieve that end we recommend that:

- a) The Milk Commission of Ontario should monitor the wholesale and retail prices of fluid milk in selected markets of Ontario on a regular basis (at least quarterly) for the purpose of identifying significant changes in prices and margins and assessing the existence or absence of effective competition in the various markets.

b) The Milk Commission of Ontario should monitor on a continuing basis the types and amounts of discounts given by fluid milk processors and distributors to their various customers and assess the effect of this practice on the structure and competitiveness of the industry.

c) The Milk Commission of Ontario should discuss any evidence of excessive margins or discriminatory trade practices considered to be detrimental to the public interest with the offending parties and, if necessary, publicize any such evidence.

3. We believe that the substantial increase in the returns of fluid milk by retailers to their suppliers which has occurred in recent years has added a significant cost to the fluid milk marketing system. We recommend that more effective control procedures be implemented at the processor, distributor and retail levels.

We also recommend that only damaged or defective product be accepted as store returns.

4. We recommend that the Ontario division of the Consumers' Association of Canada and other consumer oriented agencies should be encouraged to consult with the appropriate producer, processor, distributor, retail and government organizations on matters related to fluid milk.

We recommend that such consumer oriented agencies be encouraged to keep consumers informed on matters related to fluid milk.

PART A

THE DAIRY INDUSTRY IN ONTARIO

CHAPTER 1

BACKGROUND, SCOPE AND OBJECTIVES OF THE INQUIRY

The nutritive qualities of milk and other dairy products have been well established by nutritionists. Milk is an exceptionally good source of protein, calcium and B vitamins. It is often referred to as the nearly perfect food because it contains a balance of most of the nutrients required in the human diet. Canada's Food Guide, established by Health and Welfare Canada, identifies five types of food required in a balanced nutritious diet and recommends a daily intake of 1½ to 4 cups of milk per person.¹

In view of the importance of milk in the human diet, it is not surprising that consumers are very sensitive to milk price increases. During the period immediately prior to the establishment of this Inquiry, the prices of most consumer goods increased substantially. From July 1972 to July 1975 the Consumer Price Index for Canada increased by 33 percent while the food component of this index increased by 53 percent. During this same period the retail price of fluid milk in Ontario increased by 65 to 70 percent.² Prior to this period fluid milk prices had been increasing gradually, but the frequent and substantial price increases, particularly during 1974 and early 1975, aroused

¹ Canada's Food Guide recommends the following daily milk intake:

children (up to 11 years) - 2½ cups
adolescents - 4 cups
adults - 1½ cups
expectant and nursing mothers - 4 cups.

² Based on the unweighted average retail prices of standard milk reported in Ontario Ministry of Agriculture and Food. Monthly Dairy Report August 1975 No. 450.

concern among consumers as to their justification. In response to these concerns, a Public Inquiry was established under the direction of The Milk Commission of Ontario.

The retail price of any product is a composite of the costs and profits which are realized at the various stages in the processing and marketing system. Thus, determining whether pricing practices can be justified involves an examination of the relationship between costs and margins at the various stages involved in the production and marketing of the product.

As will be noted in the Terms of Reference for this Inquiry, this investigation was directed to the pricing practices and margins of fluid milk in Ontario in the processor, distributor and retail sectors of the industry. The prices received by producers for fluid milk did not form part of the Inquiry.

The prices paid to the producers (set by The Ontario Milk Marketing Board) are subject to the appeal provisions of The Milk Act. The prices charged for fluid milk by processors, distributors and retailers in Ontario are not subject to appeal and are free to vary in response to competitive forces at work in the market.

The consumers, through the Consumers' Association of Canada (Ontario), expressed concern about escalating fluid milk prices and requested The Milk Commission of Ontario to investigate the justification for these increases at the processor, distributor and retail levels.

While the Terms of Reference as stated encompassed all fluid milk products¹ the main thrust of the investigation was on homogenized, partly skimmed (2%) and skim milk.

¹Defined under Regulation 589, section 2 of The Milk Act to include: buttermilk, cereal cream, chocolate dairy drink, chocolate milk, fruit-flavored dairy drink, fruit-flavored milk, homogenized standard milk, lactic milk, partly-skimmed milk, skim-milk, special milk, standard milk, sterilized milk, table cream and whipping cream.

These three products account for over 90 percent of the sales of fluid milk products in Ontario.

Thus, the primary objectives of the Inquiry were:

- 1) to determine the margins at different stages in the movement of fluid milk from processor through to the consumer during the period 1972 to 1975
- 2) to determine how these margins vary between different processors, distributors and retailers and how they vary from region to region within Ontario
- 3) to determine the extent to which pricing practices and margins vary within a corporate organization
- 4) to examine and compare retail margins and discount practices in Ontario with those in other jurisdictions and
- 5) to evaluate these findings in terms of their effect on the dairy industry and the consumers of fluid milk in Ontario.

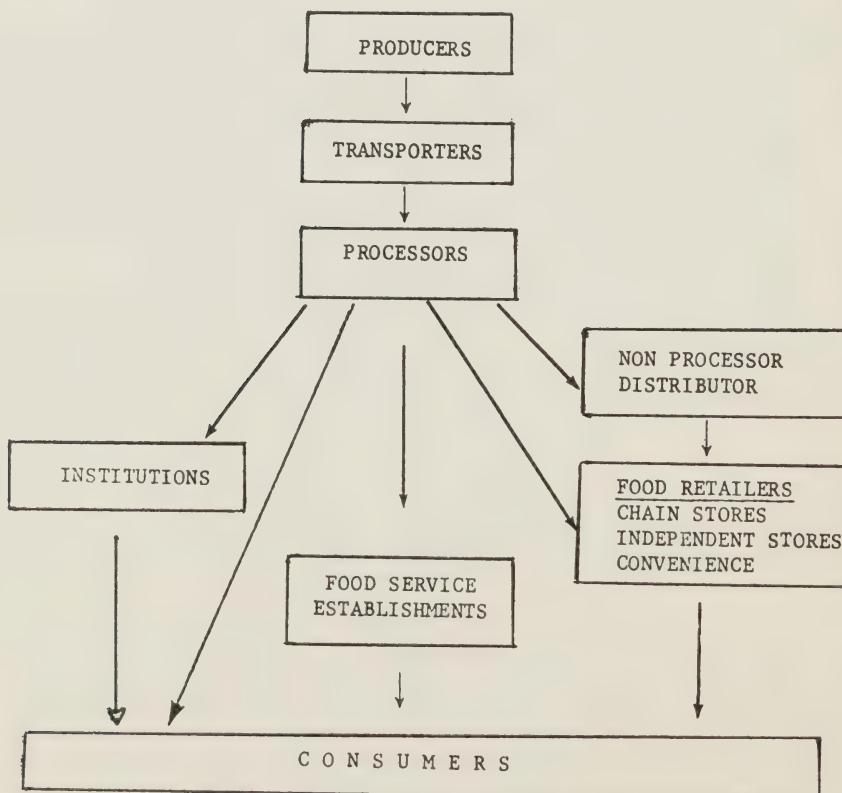
CHAPTER 2

STRUCTURE OF THE FLUID MILK INDUSTRY IN ONTARIO

The production and distribution of fluid milk in Ontario is a complex process involving a considerable amount of regulation and control by both the federal and provincial governments. The purpose of this chapter is to provide a brief description of the main features of the system through which fluid milk moves from the production stage to the consumer market. The major trends which have taken place in the processing, distributing and retailing sectors will be discussed. Figure 1 identifies the major sectors of the fluid milk industry in Ontario and indicates the various channels through which fluid milk moves from producers to consumers.

FIGURE 1

MARKETING CHANNELS OF FLUID MILK IN ONTARIO



a) Production

As of August 1975 there were 16,002 milk producers in Ontario of which 8,267 were supplying milk to the fluid milk market.¹ In order to qualify as fluid shippers, these farmers must meet the standards set down in provincial government regulations with respect to farm premises, sanitation and milk quality. In addition, each of these farms must maintain their production at a certain minimum level from month to month throughout the year in order to retain their eligibility to supply the fluid milk market. The other milk producers in the province do not have to meet as many requirements as the fluid shippers. Their milk is used in various manufactured dairy products such as cheese, butter, milk powder and evaporated milk.

The price received by producers for milk sold in the fluid market is higher than the price received for milk sold for industrial uses. Since April 1, 1975 fluid milk shippers in Southern and Northern Ontario have received \$12.01 and \$12.58 per cwt respectively FOB processing plant for that portion of their milk shipments that was used for fluid milk.² The price paid by industrial milk plants for milk used for manufacturing purposes varies according to the product into which the milk is processed. As of June 1, 1975 these prices ranged from \$8.21 per cwt for milk used for the manufacture of butter and powder to \$8.85 per cwt for milk used to produce cottage cheese, yogurt and fluid creams. In 1975 approximately 46 percent of the volume of milk marketed by producers in Ontario was used for fluid purposes.

The Ontario Milk Marketing Board is a producer organization established under The Milk Act, 1965, which has been delegated certain authorities with respect to pricing, quotas, pooling, transportation and other matters

¹The Ontario Milk Marketing Board

²Based on milk testing 3.5 percent butterfat

relating to the marketing of raw milk. All raw milk in Ontario is marketed through The Ontario Milk Marketing Board. The legislation provides the Board with the authority to determine the price that processors will pay for fluid milk purchased from it. This aspect of the Board's authority is discussed in more detail in Part C, chapter 1.

b) Transportation

The Ontario Milk Marketing Board is responsible for the movement of milk from farms to processing plants. To provide this service the Board enters into contracts with various milk transporters each of whom is licensed as milk samplers and graders under regulations laid down by the provincial government.

The transportation policy of the Board provides that transportation costs borne by the producers are pooled by region. Thus, each fluid milk producer in a region is charged the same transportation rate irrespective of the distance of his farm from the plant to which his milk is delivered. Since this policy came into effect, the location of fluid milk farms in relation to the location of the fluid milk plants has become much more dispersed than it was previously. This development has been further accentuated by the closing down of many smaller local dairies and the trend toward concentration of processing plants in the larger cities. Since it assumed responsibility for transportation, the Board has done much to rationalize transportation routes and thereby reduce transportation costs. In 1975 the costs to the producers of transporting fluid milk to plants amounted to about 4.4 percent of the gross value of their milk sales.

c) Processing

Fluid milk processors standardize, homogenize, pasteurize and package the raw milk. Except for homogenizing, these processes must be carried out in compliance with certain standards set down in provincial and/or federal

legislation. These standards have been designed to give the consumer adequate protection with regard to the quality and uniformity of the product.

The fluid milk market in Ontario is characterized by a variety of packages including the pint and half-pint containers suitable for individual servings, the quart and multiple quart containers (paper, jug and plastic pouches) for home use and the five gallon container for institutional use.

Some processors confine the bulk of their activities to the physical processing of milk and rely on other firms to distribute and retail their products while other processors are involved in these activities as well, including home delivery service direct to the consumer. Some of the larger processing plants have established a chain of milk specialty stores through which they market the bulk of their production and some have entered into agreements to supply milk distributors with their packaged milk products. Obviously, there is considerable variation in the kinds of marketing activities performed by fluid milk processors, thus making it difficult to describe the average fluid milk processor.

All fluid milk processing plants in Ontario are required to have a licence issued by the provincial government. To obtain this licence the applicant must meet the requirements of the regulations with respect to sanitation, financial responsibility and quality of product. Each licence specifies the region within which the holder may deliver milk.¹

In 1974 there were 82 processors licensed in Ontario as compared with 198 in 1968. The volume of milk processed by these firms in 1974 varied from less than 5 million pounds to over 300 million pounds per year as shown in Table 1.

¹See Exhibit 3, Distribution areas and districts in Ontario.

TABLE 1

SIZE DISTRIBUTION OF FLUID MILK PROCESSING
PLANTS, ONTARIO, 1974

<u>Size Category</u> <u>(Million pounds)</u>	<u>Number of</u> <u>Plants</u>	<u>Percent</u>
Less than 5.0	25	30.5
5.0 - 14.9	24	29.3
15.0 - 34.9	15	18.3
35.0 - 74.9	11	13.4
75.0 - 154.9	3	3.6
155.0 and over	4	4.9

Source: Ontario Ministry of Agriculture and Food.
Milk Industry Branch

d) Non-Processor-Distributors

Non-processor-distributors are firms which distribute fluid milk products but do not have their own processing facilities. As indicated previously they obtain their supplies from a processor under a contract arrangement. Generally they are relatively small firms. They account for a significant share of the home delivery business and also are important suppliers of the independent retail stores. Some distributors previously had their own processing plant but as sales of fluid milk through retail outlets increased their market was reduced to the point where it was no longer economical to operate their own processing facilities. There were 188 non-processor-distributors licensed in Ontario in 1974 and this number had increased slightly over previous years.

e) Retail Stores

At the present time a relatively small percentage of the fluid milk consumed in Ontario is delivered directly to the home as compared to about 74 percent 30 years ago.¹ Thus, the retail store has become the predominant source of fluid milk for the consumer. It has been estimated that in 1975 there were 6,298 retail food stores in Ontario of which 4,570 were independents. Of the remainder, 683 were

¹Ontario. Royal Commission on Milk Report, 1947, Toronto, King's Printer p. 89

classified as supermarket chains and 1,045 as convenience chains. Together the chain stores accounted for about 73 percent of the total dollar sales of food stores.¹

The convenience chains have become an important retail outlet for fluid milk in Ontario. At the present time most of these stores are integrated with three of the large milk processing firms.² Each of these convenience chains was established to capture a share of the retail market in the face of declining home delivery sales and increased competition from the supermarket chains.

While these stores offer a limited number of food products, fluid milk is one of the main items used by them to build trade. In a survey conducted by the Food Prices Review Board in 1974 it was estimated that dairy products accounted for 32 percent of their total sales.³

f) The Consumer Market

A significant feature of the consumer market for fluid milk in Ontario is the share of total sales which occurs in the large cities. In 1974 about 29 percent of consumers' fluid milk purchases of homogenized, partly skimmed (2%) and skim milk were made in Metro Toronto, and an additional 20 percent were made in Hamilton, London, Windsor and Ottawa. Thus, almost half of fluid milk purchases in the province were made in these five cities.⁴

Another interesting feature of the Ontario market

¹Canadian Grocer. February 1976 p. 62

²The Becker Milk Company Limited (Beckers); Silverwood Industries Limited (Mac's) and Royal Oak Dairy, Limited (Bantam and Astro Variety)

³Food Prices Review Board. Convenience Food Stores Survey, Ottawa, November 1975 p. 18

⁴Ontario Ministry of Agriculture and Food. Economics Branch. Annual Dairy Statistics 1974, Monthly Dairy Report No. 444A

is that the per capita consumption of fluid milk (including cream) is among the highest of the provinces in Canada. According to the data shown in Table 2 Ontario had the highest per capita consumption until 1975 at which time it dropped below that reported for Nova Scotia.

In recent years The Ontario Milk Marketing Board has developed a major promotional program to arrest the long term trend toward declining per capita consumption of fluid milk. While this program has undoubtedly had some of the desired effect, it was not able to offset completely the depressing effect on fluid milk sales of the substantial increases in the retail price of fluid milk in 1974 and 1975.

In 1971 the percentages of fluid milk consumed as homogenized, partly skimmed and skim milk were 52.2, 43.3, and 4.5 percent respectively. By 1975 the corresponding percentages were 45.8, 49.3, and 4.9 percent, indicating a trend toward preference for milk of lower fat content.

TABLE 2

PER CAPITA CONSUMPTION OF MILK AND CREAM
BY PROVINCE, 1964 TO 1975*

	1964	1965	1966	1967	1968	1969
	Per Capita Consumption (lbs.)					
P.E.I.	203	200	198	182	174	164
N.S.	259	262	263	267	263	258
N.B.	248	256	257	243	229	217
Que.	261	262	253	243	229	219
Ont.	306	306	301	292	288	285
Man.	259	259	257	254	248	239
Sask.	203	206	206	205	202	197
Alta.	243	249	246	236	233	235
B.C.	270	274	273	271	261	257
	1970 (lbs.)	1971 (lbs.)	1972 (lbs.)	1973 (lbs.)	1974 (lbs.)	1975 (lbs.)
P.E.I.	176	183	196	208	210	210
N.S.	260	268	272	269	274	273
N.B.	212	213	215	212	212	208
Que.	224	226	223	228	234	221
Ont.	282	278	282	282	279	269
Man.	241	243	251	262	258	251
Sask.	198	204	214	215	215	206
Alta.	242	243	247	250	254	247
B.C.	265	265	268	270	275	269

* Excludes Newfoundland. Data on fluid utilization were obtained from issues of Dairy Review (Statistics Canada Cat. No. 23-201); population figures are annual estimates made in Estimated Population of Canada by Province (Statistics Canada Cat. No. 91-201). By dividing the former by the latter per capita utilization was obtained. These data sources were used to place all provinces on a comparable basis but do not include milk consumed on farms.

CHAPTER 3

CHANGING ROLES OF PROCESSORS AND DISTRIBUTORS

Brief reference was made in the previous chapter to the changing roles of the processors, distributors and retailers in the marketing of fluid milk. In this chapter the significance of these changes will be examined in more detail.

Between 1968 and 1974 the number of fluid milk processing plants in Ontario declined from 198 to 82. This rapid decline in plant numbers occurred partly because of a relaxation of government regulations which had previously restricted the market area in which each plant could distribute milk. With the change in regulations in 1967, Southern Ontario was divided into 10 regions (see Exhibit 3) and any plant that was licensed in a region was able to distribute milk anywhere within that region. Any plant wishing to distribute milk in a region for which it was not licensed frequently purchased an existing plant in that region. As a result of this change in the licensing regulations many of the smaller processing plants were purchased by larger firms and the processing operation was consolidated.

At the same time as this development was occurring there was an increase in the number of firms which did not have their own processing facilities but served as distributors for the processors. The changes in numbers of licensed fluid milk processors and distributors are shown in Table 3.

TABLE 3

NUMBER OF FLUID MILK PROCESSORS AND DISTRIBUTORS, ONTARIO, 1968 TO 1974

	<u>Processors</u>	<u>Distributors</u>	<u>Total</u>
1968	198	143	341
1969	166	153	319
1970	138	154	292
1971	124	159	283
1972	116	117	233
1973	91	181	272
1974	82	188	270
1975	76	235	311

Source: Ontario Ministry of Agriculture and Food.
Annual Reports

As the number of processing plants in the province declined, the processing capacity tended to gravitate toward the larger centres. An indication of this trend is illustrated in Table 4 which shows the percentage of fluid milk in Ontario that was processed by the five largest processing firms in Toronto during the period 1970 to 1975.¹ It will be noted that these firms increased their share of the provincial fluid milk processing volume from 36 percent in 1970 to 45 percent in 1975. Throughout this period the population of Metropolitan Toronto was about 34 percent of the population of Ontario.

TABLE 4

PERCENTAGE OF ONTARIO FLUID MILK PROCESSED BY
FIVE TORONTO DAIRIES 1970 TO 1975

	Fluid Milk		
Total Marketed	Total Processed		Per cent of
Ontario	5 Toronto Dairies*	Total Marketed	
- million pounds -			
1970	2,308	830	35.9
1971	2,334	909	39.0
1972	2,394	965	40.3
1973	2,477	1,000	40.4
1974	2,528	1,104	43.7
1975	2,506	1,138	45.4

Sources: Ontario Ministry of Agriculture and Food.
Milk Industry Branch
The Ontario Milk Marketing Board

* The Becker Milk Company Limited, the Borden Company Limited, Dominion Dairies Limited, Donlands Dairy Ltd. and Silverwood Industries Limited

¹ See Exhibit 4 for the location of fluid milk processing plants in Ontario in 1974.

Since all fluid milk processing plants in Southern Ontario pay the same price for their raw milk supplies regardless of their location, the cost of assembling milk need not be considered by the dairies in deciding whether it would be advantageous to consolidate their plants. Metropolitan Toronto and the adjacent areas contain a substantial proportion of the provincial population. Centralizing the processing facilities in this area enables the dairies to achieve the economies of large scale processing. The main deterrent to consolidation is the cost of distributing the packaged fluid milk products. However, this factor becomes less significant with the development of large transport units and the increased importance of direct deliveries to large retail stores.

The volume of fluid milk that is delivered directly to homes at the present time is not known precisely, but is estimated to be approximately 10 percent of total sales. There is considerable variation in this figure from area to area. In general, the importance of home delivery service declines as the market area becomes more urbanized. Since 1971 the number of vehicles operated by processors and distributors for home delivery has decreased by about one third.¹

¹Ontario Ministry of Agriculture and Food. Milk Industry Branch

The decline in home delivery sales has not been confined to Ontario but has been occurring throughout Canada and the United States. A number of developments which have brought about this trend are:¹

1. Decline in frequency of home delivery service.

Due to rising delivery costs many dairies have reduced services and, in some cases, have sold or disbanded this aspect of their operation. This in turn means that many consumers are purchasing their milk in stores.

2. Higher density housing patterns. Home delivery service is more suitable for single family dwellings rather than apartments where restricted entry and the absence of suitable drop points is characteristic. As apartment living becomes more widespread, the home delivery service is replaced by store purchases of milk.

3. More aggressive merchandising by retailers. In recent years supermarkets and convenience stores have expanded in number and have pursued active programs of promoting fluid milk sales. This has had the effect of increasing wholesale operations at the expense of retail milk sales.

4. Home delivery service is most effective when direct contact is made with the consumer. In the past the housewives have performed this role. With increasing numbers of women in the labor force, many consumers have found it more convenient to buy their milk from stores.

¹Wright, R.W. and R.L. Mansell. The regulation of distributor prices for fluid milk in Alberta; study sponsored by the Alberta Department of Consumer Affairs for Public Utility Board Hearings in October 1975 pp. 18-20

5. Greater mobility of urban dwellers. With the increasing number of automobiles per family, stores have become more accessible and consequently the store purchase of fluid milk has become more common.

6. Lower unit cost at supermarkets and convenience stores. One of the major factors contributing to the shift from home delivery to store purchase of fluid milk has been the lower prices charged by supermarkets and convenience stores (Table 5). This has come about as a result of the increases in efficiency of distribution and the lower per unit processing costs achieved through larger volume.

Thus, it would appear that changes in life style and price have had a major impact in the shift away from home delivery service to the store purchase of milk. Furthermore, as dairies attempt to increase the efficiency of their distribution system, greater emphasis is placed on wholesale operations at the expense of direct retailing of fluid milk to consumers. These changes indicate that further reductions in the importance of home delivery service can be anticipated in the future.

As noted above the attraction of lower prices is an important factor in drawing fluid milk customers to stores. Table 5 provides a comparison of average store and home delivery prices in Ontario over the past five years. Not only were home delivery prices higher than store prices, but the spread between them has been increasing.

TABLE 5

 UNWEIGHTED AVERAGE RETAIL PRICES
 OF STANDARD MILK IN ONTARIO
 ON JULY 15, 1970 TO 1975

Type of Outlet	July 15 1970	July 15 1971	July 15 1972	July 15 1973	July 15 1974	July 15 1975
Independent Stores						
Cents						
1 qt.paper	35.0	36.7	37.7	41.8	45.7	58.6
2 qt.paper	67.4	70.5	71.0	80.0	87.9	114.8
3 qt.jug	87.2	89.5	88.4	100.6	113.9	149.9
3 qt.pouch pack	91.8	95.1	96.3	107.7	119.4	159.4
Corporate Chain Stores						
1 qt.paper	34.0	35.2	36.3	40.2	44.0	57.5
2 qt.paper	66.1	68.4	69.3	78.2	84.5	112.5
3 qt.jug	84.2	85.3	86.6	97.2	109.7	147.7
3 qt.pouch pack	88.8	92.7	92.9	103.7	116.2	155.6
Jug Milk Stores						
1 qt.paper	33.7	34.7	36.4	39.0	43.9	57.9
2 qt.paper	65.9	68.3	69.7	78.1	86.1	113.4
3 qt.jug	82.5	84.0	84.7	95.7	107.7	146.6
3 qt.pouch pack	87.7	90.8	91.2	102.5	114.7	154.4
Home Delivery						
1 qt.paper	35.6	37.3	39.1	43.8	47.3	61.8
2 qt.paper	69.0	71.8	74.2	83.5	90.3	118.2
3 qt.jug	94.4	96.9	99.2	110.6	120.4	161.9
3 qt.pouch pack	97.7	101.4	104.6	116.6	125.1	166.1

Source: Ontario Ministry of Agriculture and Food.
 Monthly Dairy Report August 1975 No. 450

The rapid growth of convenience stores in Ontario has been mentioned. In recent years major supermarket chains such as Dominion, Loblaws, Steinbergs, A & P, I.G.A. and Safeway have become major retailers of fluid milk.

Because these retail chains account for large volumes of milk sales, their business becomes particularly attractive

to the processors. The large deliveries associated with the supermarket business have enabled the fluid milk processors to realize certain economies in the distribution of fluid milk. However, the bargaining power of the supermarket chains has increased considerably as a result of the size of their purchases. Realizing they have a position of strength when dealing with processors, they have used a number of strategies in dealing with processors.

Knutson¹ studied some of the approached used by retailers in their negotiations with milk processors in Minnesota. He found the most common bargaining tool used to induce price and non-price concessions was the contention that a competitor had offered a lower price. The basis for bargaining for a lower price would be the savings in distribution costs as a result of the larger volume of milk purchases. Another strategy identified had retailers bluffing offers of a lower price. This strategy was confined to markets where there was a low level of price competition as in the case of small volume retailers. A third important strategy that the retailer could use in bargaining was the transfer of suppliers. If the retailer was using a private label² he could switch suppliers without the consumers' knowledge. In addition, most retailers attempted to concentrate their purchases with a single supplier so that their purchases made up a substantial proportion of the processor's total milk business. Under these circumstances the processor was in the risky position of relying heavily on one customer, thereby reducing his bargaining power when that customer requested additional considerations. Finally,

¹ Knutson, R.D. Buyer Strategy in Bilateral Oligopoly American Journal of Agricultural Economics Vol. 50, 1968 pp. 1507-1511

² Refers to a situation where the retailer has milk packaged using the store label. For example, A & P in Ontario has a major processor packaging milk in A & P cartons. This device gives retailers considerable flexibility in transferring suppliers.

the least frequent but most powerful strategy employed by major retailers was the threat of integration into fluid milk processing.

While Knutson was describing a situation existing in Minnesota, it is not known the extent, if any, the above strategies have been employed in Ontario. Furthermore, the existence of these strategies should not be construed to imply that the results would necessarily be harmful to the consumer or to the processing industry as a whole.

Unlike the convenience stores with their own source of supply and the major corporate chains or independent retail associations¹ with their buying power or integrated operations, the individual corner grocery stores have been left in an extremely vulnerable position. Because of their small volume and the corresponding high unit cost of store deliveries, the wholesale price to these stores approximates the retail price charged by supermarkets and convenience dairy stores. Consequently, the retail prices charged by individual stores are somewhat higher than those of other retail outlets.

¹For example, Red and White and I.G.A.

PART B

FACTORS CONTRIBUTING TO THE RETAIL PRICE
OF FLUID MILK 1972 TO 1975INTRODUCTION

The central purpose of this Inquiry was to determine and evaluate the pricing practices and margins of processors, distributors and retailers of fluid milk in Ontario. To assist the Commission in its task, the firm of Price Waterhouse & Co., chartered accountants, was retained to investigate pricing practices and margins between processors, distributors and retailers, to inquire into how these practices might vary within a corporate organization and between different parts of Ontario and to inquire into retail margins and discount practices from 1972 to 1975. In short, this firm was assigned the task of providing the Commission with information which would assist it in determining if the prices being charged consumers for fluid milk products were excessive in relation to costs and profits in these sectors of the dairy industry.

Because of the large numbers of businesses involved in processing, distributing and retailing fluid milk in Ontario, a series of questionnaires were developed and distributed to a representative cross section of these firms consisting of:

43 processors
63 distributors
151 retailers and
30 head offices

This sample of processing firms included all the large fluid milk processors in Ontario as well as some of the medium-sized and small plants. The 43 processing plants that were examined processed approximately 75 percent of all fluid milk in Ontario. All the large retail chains and convenience stores (which together account for about two thirds of the total retail fluid milk sales in Ontario) together with their head

offices were also included in the study.

An examination of the data supplied by the processors revealed that 93 percent of their fluid milk sales were sales of homo, 2% and skim milk in three, two and one quart containers. (See Table 6). Thus it was decided that the Inquiry would be restricted to these three fluid milk products.

TABLE 6

FLUID PRODUCT SALES AS A PERCENTAGE OF
PROCESSOR SALES BY VOLUME FOR 1974

MILK CATEGORY	5 GALLON	3 QT. JUG	3 QT. BAG	CONTAINER SIZE					TOTAL
				2 QT.	1 QT	1 PT.	½ PINT	8 OZ.	
Homo	2.60%	12.55%	9.89%	7.03%	7.54%	0.94%	0.81%	0.84%	42.20%
2%	1.78	16.96	16.67	6.11	4.01	0.00	0.03	0.15	45.71
Skim	0.20	1.20	1.06	0.71	1.61	0.02	0.11	0.11	5.02
Buttermilk	0.01	0.00	0.00	0.00	0.78	0.01	0.03	0.00	0.83
Chocolate drink	0.33	0.00	0.00	0.00	1.06	0.97	0.71	0.89	3.96
10% cream	0.15	0.00	0.00	0.00	0.66	0.13	0.04	0.00	0.98
Half & half	0.00	0.00	0.00	0.00	0.18	0.17	0.05	0.00	0.40
18% cream	0.02	0.00	0.00	0.00	0.09	0.08	0.10	0.00	0.29
35% cream	0.01	0.00	0.00	0.00	0.06	0.03	0.18	0.00	0.28
Other	0.18	0.00	0.00	0.05	0.06	0.02	0.01	0.01	0.33
Total	5.28%	30.71%	27.62%	13.90%	16.05%	2.37%	2.07%	2.00%	100.00%

Source: Questionnaire data

Not all respondents were able to supply all the information requested. Some had not been in business for the full period under review (December 1971 to June 1975); others were unable to provide historical information for the whole period. Some small firms did not have half-yearly financial statements which would have allowed them to respond to questions related to 1975 results. Comparisons of data at the beginning and end of the period must take account of these shortcomings.

The questionnaire data submitted to the Inquiry were not audited. The owner or an official of each firm completed a certificate confirming that, to the best of his knowledge and belief, the information supplied on the questionnaires was fairly presented and complete and in accordance with the records of the operating unit. Where possible, data were checked from each level of the industry against corresponding information from other levels. All significant differences were reviewed with the respondents to clarify their responses to the questionnaires.

During the period under review, costs and prices rose sharply due to inflation. From December 1971 to June 1975 the Consumer Price Index (a measure of inflation) rose from 102.2 to 137.9, an increase of 34.9 percent. Food prices in general rose even more rapidly than other consumer prices. During this same period the Consumer Food Price Index (CFPI) increased by 57.4 percent while the retail price of fluid milk in Ontario increased by 65 to 70 percent.

The Federal Consumer Subsidy on fluid milk was in effect in Ontario from October 1973 to February 1975. This had the effect of moderating increases in fluid milk prices at the farm, processor and retail levels. However, as will be noted in later chapters, major increases in retail margins on fluid milk in 1974 and 1975 and increased producer prices and processor margins in 1975 resulted in percentage increases in the retail price of milk between December 1971 and June 1975 of about the same magnitude as the percentage increase in the CFPI.

CHAPTER 1

PROCESSOR COSTS

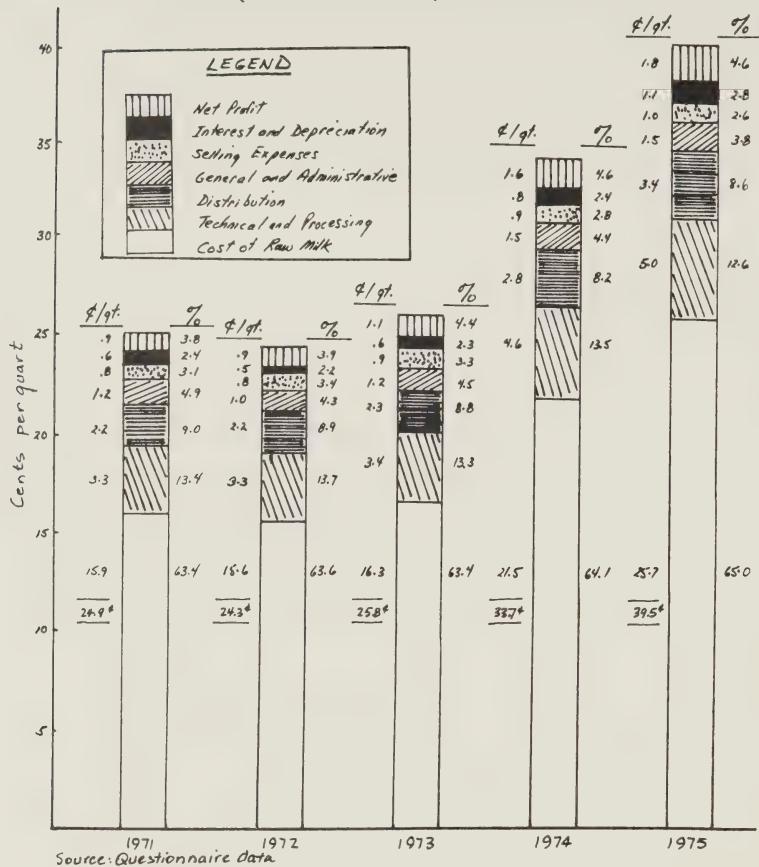
The costs of processing, distributing and retailing fluid milk in Ontario are examined in this and the next two chapters. More complete and reliable data were available on processing costs, which are greater than the costs of distributing or retailing fluid milk. Thus, the treatment of these costs is more complete than for the other two sectors.

Processors were asked to supply costs using their usual cost allocation techniques for homo, 2% and skim milk products, and to describe their approach to these calculations. These were, of course, different for each processor. Those reported in this study therefore do not, in any sense, represent "true" margins, and they are not comparable between processors. However, since each processor applied his own method of allocation consistently within the period, the resulting margin data have been used in the following chapters for assessing trends.

Figure 2 indicates trends in costs and profits as reported in financial statements of processors from 1971 to 1975. The sum of costs and net profit equals the average price per quart at which processors sold their fluid milk products to distributors and retailers. The difference between this price and the cost of the raw milk is the margin available to the processor to cover his operating costs and to provide a profit.

The most important components of the processors' costs are raw milk, labor and containers. These are discussed in detail below. In Figure 2 labor and container costs are included in Technical and Processing costs. The other cost categories identified were Distribution, General and Administrative, Selling Expenses and Interest and Depreciation.

FIGURE 2
AVERAGE PROCESSOR COSTS AND NET PROFIT
PER QUART OF MILK, 1971 TO 1975



a) Raw Milk Costs¹

Figure 2 indicates that raw milk is the major cost item to the processor. Expressed in terms of percentage of the processors' sales revenue, this cost item increased from 63.4 percent in 1971 to 65.0 percent in 1975. In determining the cost of raw milk to the processor, two factors must be taken into account. These are the value

¹See Exhibit 8, Implications of costing the raw milk content of fluid products.

of surplus butterfat and processing losses. The latter may arise through a physical loss of milk as it moves through the processing system and is called shrinkage.

Shrinkage occurs because it is physically impossible to completely empty each container of milk. Losses also arise from defective packages, spoilage and overfill, because of the federal requirement to ensure that each package will contain at least the minimum amount specified.¹ The net result is that the processor will have less milk for sale than he purchased. In-plant losses normally amount to about 1.5 percent of milk purchases. Add to this a normal procurement loss² of 0.25 percent and an allowance for damaged merchandise, and the typical plant shrinkage is about 2 percent.

Table 7 provides data on the amount of shrinkage reported by all fluid milk plants in Ontario during the past three years.

TABLE 7

SHRINKAGE LOSSES BY ONTARIO
FLUID MILK PLANTS, 1973 TO 1975

Year	Milk Purchased \$ Value (Millions)	Pounds Pounds (Millions)	Pounds Shrinkage (Millions)	% Shrinkage (Av.)	% Shrinkage (Range)	\$ Value (Millions)
1973	165.8	2,400	42.6	1.76	5.6 - 0.97	2.5
1974	217.0	2,454	49.1	2.0	6.5 - 0.91	3.58
1975	250.1	2,489	53.2	2.14	6.3 - 0.47	4.73*

Source: Ontario Ministry of Agriculture and Food.
Milk Industry Branch

* Although there was only a slight increase in the percentage shrinkage from 1974 to 1975, the value of the raw milk represented by this shrinkage increased substantially because of an increase in the price of raw milk.

Surplus butterfat is created in the processing of fluid milk whenever the raw milk purchased by the processors

¹See Exhibit 10, Fill tolerances for beverage milk products.

²Loss in volume of milk between the farm bulk tank and the plant receiving dock

has a higher fat content than the levels prescribed by government regulations for homo, 2% and skim milk. The prices paid by processors for raw milk are based on a fat content of 3.5 percent plus or minus a differential from the base price for each one tenth of a percentage point of butterfat above or below 3.5 percent. The amount of this differential varies from time to time depending upon the value of butterfat. From January 1972 to April 1975 it had increased from 6 cents to 13 cents.

Obviously, the processor incurs costs in standardizing the fat content of the raw milk to the prescribed levels for homo, 2% and skim milk. However, the surplus butterfat extracted in this process has a value which, when credited against the cost of raw milk purchases for fluid milk processing, reduces the raw milk cost to the processor.

Normal plant processing techniques are not capable of removing pure butterfat. Some skim milk along with the butterfat is removed, producing a product known as cream. Fluid milk processing plants may sell this product as cream or use it in the manufacture of ice cream. It may also be sold to industrial plants for the manufacture of butter. The fluid plants may be required to absorb the transportation costs in moving the cream to the industrial plants. In some cases, notably in Northern Ontario where the distances between plants are great, these transportation costs are substantial.

According to the Southern Ontario fluid milk processors' data, the amount of butterfat they purchased in the raw milk which was surplus to their fluid milk requirements was relatively stable from year to year. Expressed as a percentage of their total butterfat purchases it ranged from about 27.5 to 30 percent. In Northern Ontario the percentage increased from 17.2 in 1971 to 22.1 percent in 1975.

During the summer of 1975 the price of surplus cream sold by fluid plants ranged from \$1.03 to \$1.23 per pound of fat and the weighted average price was about \$1.20 per pound of fat. The net return to the fluid plants would be less than this amount because of transportation costs.

Thus, it is very difficult to determine precisely the amount by which the cost of processors' purchases of raw milk for fluid purposes should be reduced to reflect the revenue realized from surplus butterfat. Some fluid plants may dispose of it through their own cream or ice cream sales; some may transfer it to their industrial milk division while others may sell it to industrial plants. The problem is further complicated by the fact that fluid plants do not follow a uniform accounting procedure. Some fluid plants credit the proceeds from sales of surplus butterfat to the cost of raw milk entering the process; others credit it to fluid milk revenue and still others who operate both fluid and industrial divisions may credit it to industrial milk revenue.

Table 8 gives estimates of the average raw milk costs to fluid milk plants after deducting the value of surplus butterfat. It must be emphasized that these figures are based on the cost of milk purchased from The Ontario Milk Marketing Board less the value of the fluid cream used for non-fluid milk products as reported by the processors. It will be noted that these estimates of raw milk costs are different from those shown in Figure 2. The main reasons for these discrepancies are that the estimates shown in Table 8 were based on a smaller and therefore different sample of processors than those shown in Figure 2. In addition, these discrepancies are accentuated by the fact that not all processors used the same accounting procedures for crediting the value of surplus butterfat. It seems reasonable to conclude that the average cost to processors of raw milk purchases per quart of fluid milk sold is within the range of the estimates shown in Figure 2 and Table 8.

TABLE 8

AVERAGE RAW MILK COSTS AFTER DEDUCTING
VALUE OF SURPLUS BUTTERFAT

	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>
- cents per quart -					
Southern Ontario	17.3	16.7	18.3	20.6	26.5
Northern Ontario	18.1	18.5	19.3	21.2	27.2

Source: Questionnaire data

b) Store Returns

Returns of fluid milk from retail outlets to their suppliers would be expected on damaged packages or defective product such as sour off-flavored milk or short-filled packages. The problem of store returns has intensified as processors have delegated more and more responsibility to retail stores for the stocking of display cabinets and the control of in-store inventories. Drop deliveries at the dock of the retailer have reduced delivery costs to stores but have increased product returns due to poor ordering and improper in-store handling. Since early 1976 the open dating of milk cartons has increased consumer awareness of the age of products, thus there is a natural tendency to reject the oldest product in a display case and eventually cause the product to be returned to the processors. However, open dating of milk packages merely indicates to the consumer that the product is best if used before the date stated on the package. It is not illegal to sell the product after the expiry date.

The following table indicates the magnitude of store returns in millions of pounds of milk and dollar value based on the loss in value of the raw milk only.

TABLE 9

STORE RETURNS OF FLUID MILK PRODUCTS,
ONTARIO, 1973 TO 1975

Year	\$ Value of Raw Milk Purchases (Millions)	Pounds Store Returns (Millions)	% Store Returns (Av.)	% Store Returns (Range)	\$ Value (Millions)
1973	165.8	25.4	1.05	7.56 - 0 ¹	1.3
1974	217.0	28.5	1.16	3.27 - 0	1.9
1975	250.1	30.2	1.21	2.83 - 0	2.6*

Source: Ontario Ministry of Agriculture and Food.
Milk Industry Branch

* The increase in value from 1974 to 1975 was due in part to the increase in value of raw milk.

The data shown in Table 9 indicate that there was a broad range among retail outlets in the percentage of store returns. Vertically integrated processor-retail operations generally had zero or very low store returns. The value of these store returns has been increasing. If their value had been based on the processed cost of the product rather than on their raw milk value, as shown in Table 9, the values would have been about one third higher.

The cost associated with store returns can be reduced and it is of prime importance that they be minimized. All sectors of the fluid milk industry, including the consumers, stand to benefit significantly if this is achieved.

c) Labor Cost

Labor cost is the processors' second largest cost item. In Figure 2 labor cost is included in Technical and Processing costs. The need for highly skilled and careful workers in milk processing plants in Ontario is reflected by the wage rates. They are higher than the average manufacturing hourly wage rates by about 7 to 10 percent in

¹The zero and low percentage store returns were associated with vertically integrated processor-retail operations.

Southern Ontario, and recently by even greater amounts in Northern Ontario. Wages in Northern Ontario processing plants have risen more quickly than those in the South and than average manufacturing wages in Ontario generally.

TABLE 10

AVERAGE HOURLY WAGE RATES INCLUDING FRINGE BENEFITS
IN FLUID MILK PROCESSING AND GENERAL MANUFACTURING

	1971	1972	1973	1974	1975
	- dollars -				
Fluid Milk Processing *					
- Northern Ontario	3.57	3.72	4.19	5.26	5.68
- Southern Ontario	3.87	4.09	4.43	4.79	5.48
Manufacturing **					
Ontario	3.47	3.74	4.06	4.54	5.18

* Questionnaire data

** Employment earnings and hours (Statistics Canada
Cat. No. 72-002)

Table 11 shows the production of fluid milk per man hour in various regions of Ontario. Not only are labor rates higher in Northern Ontario processing plants than Southern Ontario, but the productivity per man is lower in the North. The higher productivity in Metro Toronto and Southern Ontario is related to the greater output resulting from extended hours of operation and the increasing use of continuous process machines.

The larger market in Southern Ontario compared to Northern Ontario simply means that processing plants in Southern Ontario can be utilized more efficiently than similar plants in Northern Ontario.

TABLE 11

REGIONAL FLUID MILK PRODUCTION PER HOUR BY
PROCESSING PLANT LABOR

	1971	1972	1973	1974	1975
	- cwt per hour -				
Metro Toronto	11.4	12.2	12.4	13.6	13.8
Southern Ontario (excluding Metro Toronto)	9.7	9.5	10.5	11.2	11.2
Northern Ontario	6.6	6.6	7.0	7.1	7.0

Source: Questionnaire data

An examination of Tables 11 and 12 indicates that Northern Ontario has become significantly less productive per dollar of labor than Southern Ontario. The increase in productivity per labor hour has not kept pace with the increase in wage rates in either the North or South.

d) Container Costs

Container costs, which are included in Technical and Processing costs in Figure 2, can be clearly identified with a specific final fluid milk product. To determine almost all other costs of processing fluid milk involves allocating a portion of the total cost of items such as raw milk, labor, space, machine time, trucking and administration. In analyzing the data it is apparent that three quart containers dominate the Ontario fluid milk market and now account for over 60 percent of sales. The three quart plastic bag has continued to grow in popularity at the expense of the three quart jug and the smaller containers to the extent that if the present trend continues, it will soon become the most popular container. These trends over the past five years are illustrated in Table 12.

TABLE 12

PERCENTAGE OF FLUID MILK SALES
BY TYPE OF CONTAINER

Type of container	1971	1972	1973	1974	1975
5 gallon	4.9%	5.0%	4.9%	4.9%	4.9%
3 quart jug	39.3	35.4	34.8	33.1	32.1
3 quart bag	19.1	23.2	26.2	29.7	31.5
2 quart carton	16.8	17.0	15.8	14.9	14.2
1 quart carton	17.1	16.6	15.2	14.2	13.8
1 pint carton	0.9	0.9	1.1	1.0	1.0
½ pint carton	1.4	1.3	1.1	1.0	0.9
Other	0.5	0.6	0.9	1.2	1.6
	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Questionnaire data

The increase in cost of the different containers is shown in Table 13. The figures shown for three quart jugs do not include the cost of caps, return transportation of empty jugs, washing or disposal of effluent from washing.

TABLE 13

CONTAINER COSTS IN 1975 AND PERCENTAGE
INCREASE OVER COSTS IN 1971

Type of container	Southern Ontario		Northern Ontario	
	Cost in 1975	Percentage increase over cost in 1971	Cost in 1975	Percentage increase over cost in 1971
5 gallon	60.84c	42%	66.27c	48%
3 quart jug	48.86	36	60.35	78
3 quart bag	6.11	44	5.73	60
2 quart carton	5.22	31	5.39	38
1 quart carton	3.00	33	3.11	40
1 pint carton	2.17	29	2.51	49
½ pint carton	1.65	36	1.93	48

Source: Questionnaire data

From 1971 to 1975, the unit cost to processors of the various containers rose substantially in both Southern and Northern Ontario. In 1971 the average cost was about the same in the North and South for the smaller packages (two quarts or less), but was lower in the North for the three quart bags and jugs. Subsequently, packaged costs

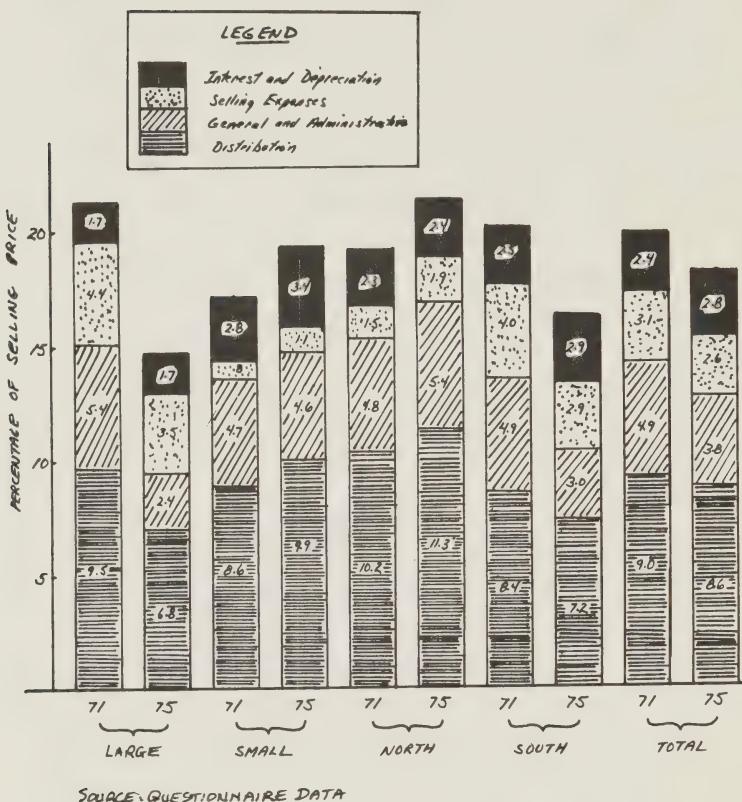
rose more rapidly in Northern Ontario, especially for bags and jugs. By 1975 only three quart bags were less expensive in the North. These higher packaged costs probably reflect lower discounts from the suppliers to Northern Ontario processors because of their smaller requirements and higher delivery costs.

In Southern Ontario the cost to processors of three quart jugs and bags remained relatively constant through 1972 to mid 1973. However, from June 1973 to June 1974 the average cost of a three quart jug increased from 37.7 cents to 47.7 cents, an increase of 27 percent. The major increase in the cost of the three quart bag occurred during 1974 when over a twelve month period it increased from 4.4 to 6.1 cents or by about 39 percent, due largely to increases in petroleum costs.

e) Other Costs

Other processing costs include distribution, general and administrative expenses, selling, interest and depreciation expenses. In Figure 3 these costs are summarized for all processors and compared for large and small processors in Northern and Southern Ontario. Seven processors were selected as the largest and seven as the smallest, based on 1974 sales. Expressed as a percentage of selling price this category of expenses decreased from 1971 to 1975 for the large processors and also for Southern Ontario processors as a group, whereas the reverse occurred in Northern Ontario and for the small processors. For all processors included in the study a slight decline was indicated.

FIGURE 3
OTHER PROCESSOR COSTS AS A PERCENTAGE
OF SALES, 1971 AND 1975



Distribution expenses varied in 1971 from 2.3 to 17.1 percent of net sales; in 1974 the range was from 2.8 to 13.2 percent. The highest percentage was among operating units in the North where distances between processor and market are greater. The average distribution expenses of all processors, expressed as a percentage of sales, declined from 1971 to 1975. However, this was not true for the smaller processors who, as a group, derived a larger share of their sales from home delivery.

General and administrative expenses declined as a percentage of sales from 1971 to 1975 for all groups shown in Figure 3, except Northern Ontario. This no doubt reflects the relatively smaller sales of the plants in the North. Similarly, selling expenses declined for all groups except for Northern Ontario and the smaller processors.

Interest and depreciation, a relatively minor cost, was most significant in the smaller processing operations. Their owners appeared to have more difficulty financing operations from retained earnings. For processors as a whole this expense item required a slightly greater percentage of sales revenue in 1975 than in 1971.

CHAPTER 2

NON-PROCESSOR-DISTRIBUTOR COSTS

Much less data were available on the non-processor-distributor¹ sector of the fluid milk industry. However, on the basis of financial statements submitted by 13 respondents it was possible to distinguish eight small distributors from five large ones, based on sales below or above \$500,000 in 1974.

Although this sample included a range of distributors from the very small to the very large, there were insufficient data from Northern Ontario to make reliable comparisons between Northern and Southern Ontario. In addition, a few distributors carried a broad range of products other than milk so that handling fluid milk products accounted for only a small proportion of their total sales and operating costs. The reported data segregated the sales of fluid milk from other products, but this was not the case with costs. As a result, some cost trends shown in this chapter may reflect influences from factors not associated with fluid milk product distribution. Thirty-five percent of the respondents, many of whom were formerly fluid milk processors, said that they were subsidiaries of limited companies. Less than 10 percent of the respondents were sole proprietorships whose costs probably did not include an allowance for the owners' salaries, and 55 percent were independent limited companies. Many of the smaller distributors delivered a portion of their sales directly to homes at retail prices. Their sales and cost figures are therefore not always comparable to those of the larger firms.

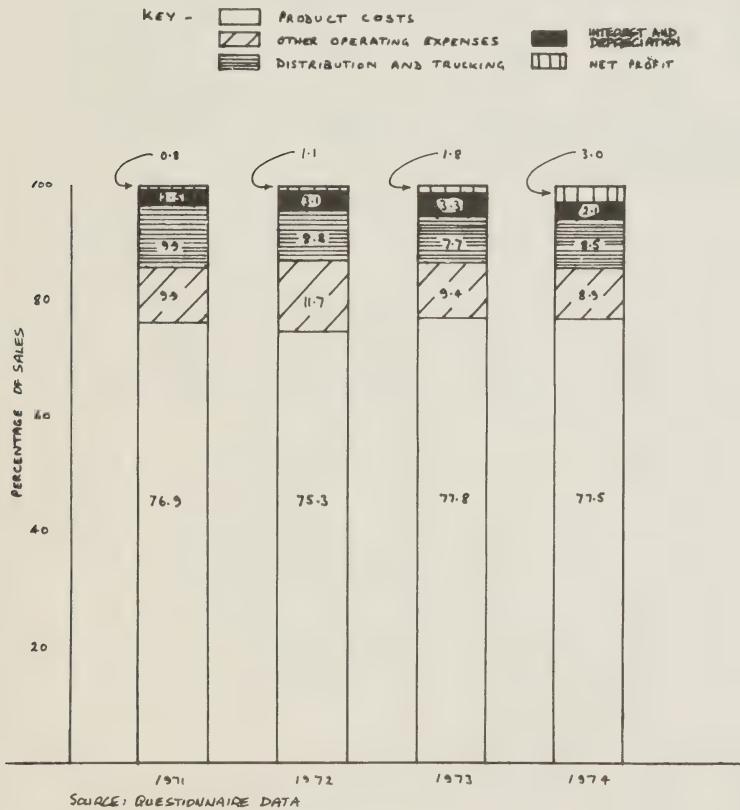
Figure 4 shows average distributor costs, including product costs, other operating expenses, distribution and trucking, interest and depreciation, and net profit, as a percentage of sales over the four year period from 1971 to 1974. Audited statements for 1975 were not available because financial statements for distributors are generally produced yearly and were not available at the time the study

¹ Hereafter called distributors

was conducted. Figure 4 illustrates the relative importance of each of these elements in the four years for which data were available.

FIGURE 4

AVERAGE NON-PROCESSOR-DISTRIBUTOR COSTS AND
NET PROFIT AS A PERCENTAGE OF SALES
1971 TO 1974



It will be noted that the average distributors' operating expenses as a percentage of sales declined from 1971 to 1974 while their product cost and net profit ratios increased.

a) Product Cost

Table 14 shows the average product cost of the distributors as a percentage of their total sales (not all of which would be sales of fluid milk products) and the

relative position of the small and large distributors from 1971 to 1974.

Because the distributor is a middleman between processor and retailer, operating usually on a relatively stable markup percentage, it would be expected that his product costs and sales would vary proportionately. The relative stability of the percentages shown in Table 14 confirm this.

TABLE 14

AVERAGE NON-PROCESSOR-DISTRIBUTOR PRODUCT COST
AS A PERCENTAGE OF SALES

Size Group	1971	1972	1973	1974
Under \$500,000 net sales, 1974	78.7%	75.9%	79.0%	77.6%
Over \$500,000 net sales, 1974	73.7	74.3	77.1	77.4
Total group	76.9	75.3	77.8	77.5

Source: Questionnaire data

For the group as a whole, the average increase in product costs as a percentage of sales over this time period was very slight - less than one percent. Also, the difference between the ratios of the large and small distributors appears to have lessened.

b) Other Operating Expenses

Labor was the largest component of the "Other Operating Expenses" category.

The costs of distribution and trucking as a percentage of sales were about the same for the small and large distributors. A comparison of these two groups in terms of fluid milk sales per mile of truck travel is given in Table 15.

TABLE 15

NON-PROCESSOR-DISTRIBUTORS' FLUID MILK SALES*
PER MILE OF TRUCK TRAVEL

	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975**</u>
Sales (\$000)	2,415	2,657	3,365	6,314	9,956
Miles of truck travel	325,000	368,000	392,600	680,400	901,780
All distributors	\$7.43	\$7.22	\$8.57	\$9.28	\$11.04
Distributors with:					
Sales over \$500,000	\$16.84	\$14.30	\$15.36	\$17.79	\$13.42
Sales under \$500,000	\$6.08	\$5.20	\$6.87	\$6.73	\$9.34
Sales (reduced by the Consumer Price Index deflator) per mile of truck travel:					
All distributors:	\$7.43	\$6.82	\$7.53	\$6.96	\$6.85
Distributors with:					
Sales over \$500,000	\$16.84	\$13.51	\$13.49	\$13.34	\$8.33
Sales under \$500,000	\$6.08	\$4.91	\$6.03	\$5.05	\$5.80

Source: Questionnaire data

* Only distributors giving both mileage and sales data were considered.

** Estimated by respondents.

Although the dollar sales per mile of truck travel showed some increase over the period, this was due to an increase in the unit price of the products sold rather than an increase in the number of units sold. When the dollar sales were deflated by the Consumer Price Index to reflect changes in quantity sold, it became evident that there had been a declining trend in quantity sold per mile of truck travel for both the large and small distributors.

The big increases in mileage travelled in 1974 and 1975 were the result of the entry of new distributors into the business or consolidation of old businesses under a new name, and not from a general increase in distributor activity. Several respondents to the

questionnaire had a history shorter than five years. Lacking from the data is the input of those distributors who left the business before the questionnaire was distributed.

Interest and depreciation are of little importance in understanding increases in distributors' costs. It does appear that the smaller distributors, because they have less equity capital, depend more heavily on debt financing and consequently have higher interest costs.

Referring again to Figure 4, it will be noted that the group of 13 distributors included in this study increased their net profit as a percentage of sales from 0.8 percent in 1971 to 3.0 percent in 1974. While the latter figure does not represent an excessive profit margin, it does suggest that the many adjustments and consolidations that have been and are being made in this sector of the industry have resulted in making it more financially sound.

CHAPTER 3
RETAILER COSTS

Retailing involves various costs including those of both labor and space. Modern retail stores handle such a large number of items that it is impractical to determine the actual cost of retailing each individual item. The typical practice of the large retail chains is to maintain its basic accounting records in terms of three departments: groceries, meat and produce. Milk is usually included as one of the items in the grocery department. This chapter provides a review of milk retailing operations and tentatively suggests some influences which may have an impact on retail margins in the sale of fluid milk products.¹

a) Product Cost

The cost of the fluid milk product as it enters the retail outlet is not difficult to determine. This is equivalent to the price the retailer pays the processor or distributor for the packaged milk products and is the largest single component of the retailing costs of every fluid milk product. Table 16 gives the average net cost to the retailer, after allowance for discounts and weighted by size of package, of a quart of 2% milk in Metro Toronto and in Northern and Southern Ontario from December 1971 to June 1975.

TABLE 16

AVERAGE PER QUART COST OF 2% MILK
 TO RETAILERS*

	Dec. 1971	June 1972	Dec. 1972	June 1973	Dec. 1973	June 1974	Dec. 1974	June 1975
- cents per quart -								
Northern Ontario	30.8	30.5	30.6	33.7	33.0	37.0	42.9	50.7
Southern Ontario (excluding Metro)	27.6	27.0	26.8	29.9	29.4	33.8	39.0	45.6
Metro Toronto	26.1	24.9	24.7	27.6	26.6	30.8	35.9	42.3

* The Federal Consumer Subsidy was five cents per quart from October 1973 to October 1974 and two cents per quart from then until February 1975.

¹For a more detailed discussion of retail store management

During the period under review the average cost per quart of 2% milk to retailers increased by about 65 percent in Northern and Southern Ontario and by about 62 percent in Metro Toronto. This compares with an increase of 57.4 percent in the CFPI during the same period. The rise in cost which was occurring was arrested by the introduction of the Federal Consumer Subsidy in October 1973. However, it was not sufficient to offset the inflationary pressures on costs throughout the milk production and distribution system. Thus, throughout 1974 and up to June 1975 the cost to the retailer increased more rapidly than the CFPI.

The fluctuations in product cost were slightly more extreme in Metro than elsewhere in Ontario. The decline in prices from December 1971 to December 1972 and from June 1973 to December 1973 was proportionately greater than in the rest of the province, but after December 1973 product costs rose more rapidly for Metro retailers.

Table 17 shows the average percentage increase in the cost of homo, 2% and skim milk in various package sizes to retail chain stores from December 1971 to June 1975. In Southern Ontario the cost of skim milk increased more than homo and 2% while in Northern Ontario 2% milk showed the greatest increase. In terms of packages, jug milk increased by the largest percentage thus raising its price closer to that of milk in the other types of containers.

TABLE 17

PERCENTAGE INCREASE IN NET COST OF FLUID MILK TO
RETAIL CHAIN STORES, DECEMBER 1971 TO JUNE 1975

	<u>Southern Ontario</u>	<u>Northern Ontario</u>
<u>1 quart jugs:</u>		
Homo	62%	63%
2%	68	74
Skim	79	58
<u>1 quart bags:</u>		
Homo	62	53
2%	66	58
Skim	63	54
<u>2 quart cartons:</u>		
Homo	59	58
2%	55	63
<u>1 quart cartons:</u>		
Homo	57	50
Skim	62	68

Source: Questionnaire data

These variations in percentage increase in net cost to retailers by type of milk and container suggest that processors were basing their selling prices on factors other than cost increases alone. If the cost increases which they incurred during the period had been passed on to the retailers on a uniform basis for each type of milk and container, then the percentage increases shown in Table 17 would have been identical. On the other hand, if the cost increases associated with each type of container had been passed on by the actual amount of these increases, then, because of its lower base value, the percentage increase on skim milk would have been greater than that on homo or 2%.

The latter explanation appears to be more consistent with the data shown in Table 17. However, there are sufficient exceptions to this pattern to indicate that in establishing their selling prices processors took into consideration the relative strength of the demand for the different types of fluid milk in the various containers.

b) Operating Costs

The largest single operating cost of retailing is labor. As a percentage of total sales in chain stores, labor cost remained an almost constant eight percent over the period. Data submitted by independent or franchised retailers did not permit similar calculations to give a broader picture of labor costs in the retail industry. In general, jug milk stores would utilize a higher proportion of their labor in the handling of fluid milk products than would chain stores.¹ The opposite is likely true for neighborhood stores where the distributor often maintains and displays the retailer's stocks.

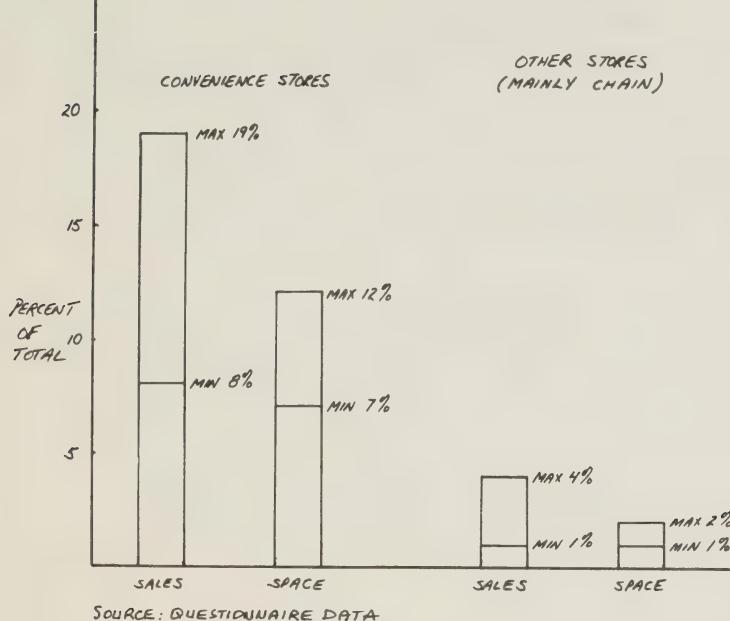
Other costs are relatively small as a proportion of sales. They include display and warehousing costs, advertising, selling, interest and depreciation.

Figure 5 indicates the relationship between sales of fluid milk products and display and warehousing space requirements as reported by jug milk and convenience stores and by other stores, mainly chains. The data suggest a relatively greater space cost per dollar of sales of fluid milk products in jug milk and convenience stores.

¹In a 1974 survey, dairy products accounted for 32 percent of convenience stores' total sales. Food Prices Review Board. Convenience Food Store Survey, November 1975 p. 18

FIGURE 5

COMPARISON OF MILK SALES AND SPACE
REQUIREMENTS IN CONVENIENCE STORES
AND OTHER STORES (MAINLY CHAINS), 1975



As already indicated, accounting procedures of retail firms do not segregate the costs of retailing fluid milk products from the costs of retailing other merchandise. Most major retail outlets divide their marketing activities into three departments: groceries, produce and meat. Fluid milk products are not created separately but are usually included in the "grocery" category.

We have been advised by our Financial Counsel that this is in accordance with accepted accounting principles, inasmuch as the marketing executive focuses his attention on gross profits¹ of departments rather than on the margins or profits realized on individual items. From the data

¹Gross profit is the difference between selling price and cost of goods purchased.

available, and because of the accounting procedures used by retailers, the Inquiry was unable to determine the costs of retailing fluid milk.

Space costs can only rarely be divided between fluid milk and other products. Transportation costs are not separately maintained for fluid milk products if and when these products are being carted with other goods. Retailers do not distinguish checkout counter costs appropriate to the fluid milk products portion of a customer's total purchases.

There is no difficulty in determining the cost of fluid milk to the retailer as it enters his store; there is also no difficulty in being able to determine the price the retailer charges the consumer for the same item. But from the difference between these two figures must be deducted the operating costs of the retailer such as labor, rent, fuel, electricity and advertising in order to determine his net profit on fluid milk.

Unless the costs associated with retailing milk can be determined, it is not possible to calculate the profits realized from that activity. Therefore, any assessment of whether the prices charged for fluid milk by retailers were reasonable or otherwise must be based on other evidence.

To obtain more complete and precise estimates of the costs of retailing fluid milk would have required a very detailed and time consuming study of retail operations. The first step in such a study would be to decide the basis on which those costs, which are borne by the various items of merchandise in the retail outlet, are to be allocated to the various products. There are various acceptable bases which could be used, but each would produce different cost estimates for the individual products and each would have specific limitations. The second step would involve collecting the required data from a representative sample

of retailers. Since these data are not recorded in the accounting records of retail firms, only current data could be obtained by such a survey. Thus, it would not be possible to ascertain how the various cost items may have changed over the study period and thereby determine their relationship to changes in the retail price and retailers' margin on fluid milk. Because of the fundamental problems involved in estimating the operating costs associated with retailing fluid milk we have had to resort to secondary sources of data on this aspect of the Inquiry.¹

Several recent studies have been conducted in the United States which provide estimates of the costs of retailing fluid milk. These are summarized in Table 18.

TABLE 18

COMPARATIVE COSTS OF RETAILING MILK IN
ALABAMA, CALIFORNIA, SOUTH CAROLINA
AS A PERCENTAGE OF SALES

	Chain Stores	Neighbourhood Stores	Jug Milk and Convenience Stores
Alabama	7.0%	5.9%*	8.2%
California	14.8	16.8	26.6
South Carolina	9.1	7.5	10.0

Sources: University of Alabama. Cost of Retailing Milk in Alabama, 1974, a study for the Alabama Dairy Commission

California Department of Food and Agriculture. Bureau of Milk Stabilization. Outline of Procedures for Determination of Cost of Handling Controlled Dairy Products in Retail Stores, January 1975

Case and Company, Inc. A Report on the Cost of Producing, Processing, Distributing and Selling Milk in South Carolina, for the Dairy Study Committee of the South Carolina Legislature, March 1974

* Owner's salary excluded totally or partially from costs.

¹ See Exhibit 9, Pricing strategy.

On the other hand, the studies in the United States referred to in Table 18 are based on different costing methods as follows:

Alabama - This cost study approaches costing determination through time and activity measurement. Only a limited amount of arbitrary cost allocation is used. Space costs were allocated on the basis of turnover ratios, and as these ratios are much higher than were reported in Ontario a comparison of the results might be misleading.

California - This costing procedure has been in use for approximately 10 years and has been updated and improved over that period of time. The procedure is based on direct costing and allocation. The results may be questioned as space costs and utility expenses are allocated on the basis of sales. Indications from other studies and from Ontario questionnaire data are that the turnover ratio for milk to other products can vary from 2 to 1 to 18 to 1, depending on the store's location. Such a variation has a substantial effect on the per square foot cost of a product's space requirements. An allocation of space costs on the basis of sales may grossly overestimate those costs.

South Carolina - This study segregated and studied specific operations to determine labor expenses, floor and space expenses and depreciation expenses in fluid milk product retailing. Expenses such as general overhead store management and corporate expenses were allocated on the basis of dollars of sales.

It is apparent that there are wide variations in the estimates of operating costs which may be associated with the retailing of fluid milk products. None of the data examined can be said to truly represent the costs of retailing milk in Ontario. These various estimates would suggest that the average retailing cost of fluid milk expressed as a percentage of sales is probably in the 10 to 15 percent range with chain stores having a somewhat lower

cost ratio than the convenience stores.

In brief, the cost of raw milk represented 53.0, 52.8, 52.2, 52.5 and 54.3 percent of the retail selling price for fluid milk for the years 1971 to 1975 respectively. Over the five years from 1971 to 1975 inclusive, the average cost of raw milk to the processors amounted to about 53 percent of the average retail price of milk in Ontario. It is of interest to note that during this same period the farmer's share of the retail price of fluid milk in the United States was 51.5 percent.¹ This figure did not include the costs of assembly and procurement which, in Ontario, is borne by the producers.

The operating costs of the processors and distributors amounted to 24.2 and 1.2 percent of the retail price respectively.

¹U.S. Department of Agriculture. Economic Research Service. Marketing and Transportation Situation, February 1974 p. 40

_____. Agricultural Outlook, August 1976 p. 25

CHAPTER 4
PRICING PRACTICES

This chapter deals with pricing and discount practices and highlights the different arrangements in effect in the various sectors of the industry. The effects of those practices on the margins obtained are discussed. None of the practices outlined in this chapter is unique to the fluid milk industry; indeed they are the rule, rather than the exception.

a) List Price

List price refers to the price for a specific fluid milk product published by the supplier on a price list. A price list serves more than one purpose. It may indicate to a retailer the price at which a supplier would like his product offered to the public, though the retailer is not obliged to adopt such a suggestion. It may have the psychological effect of pointing out to the retailer the amount of bargain he is gaining after a discount is negotiated, or, it may actually serve as a basis for negotiating discounts with different classes of customers. A price list might also have the effect of concealing what one class of customer is paying for a product as distinguished from another class selling the same product. Whatever its purpose, it is a fact that it is only very rarely that the list price is equal to the actual price. Discounts are used as the means of reducing the list price to a net price. Emphasizing trends on either list prices or discounts could therefore be misplaced. Only when considered together do they have a meaning which generates the "real" or net price that is the actual basis of transactions between sellers and buyers.

Table 19 illustrates the relationship of the processor list price to the retailer, the actual price paid by the retailer after the discount (net price), and the retailer's selling price for homo milk in three quart

jugs from December 1971 to June 1975. These various prices are compared for Southern Ontario, excluding Metro Toronto, and for Metro itself. It is evident from this table that there was no fixed relationship throughout the period between the list price, net price to the retailer and the retail price.

TABLE 19

COMPARISON OF PROCESSOR LIST PRICE, NET PRICE AND RETAIL PRICE FOR HOMO MILK IN THREE QUART JUGS FOR METRO TORONTO AND SOUTHERN ONTARIO EXCLUDING METRO

Southern Ontario
(excluding Metro)

	Dec. 1971	June 1972	Dec. 1972	June 1973	Dec. 1973	June 1974	Dec. 1974	June 1975
Retail Price	\$0.85	\$0.86	\$0.85	\$0.96	\$0.94	\$1.08	\$1.27	\$1.46
List	0.85	0.84	0.84	0.93	0.92	1.06	1.22	1.44
Net	0.75	0.73	0.73	0.80	0.78	0.90	1.04	1.23

Metro Toronto

Retail Price	0.84	0.84	0.85	0.94	0.91	1.06	1.24	1.43
List Price	0.82	0.82	0.79	0.89	0.86	1.00	1.16	1.39
Net Price	0.73	0.71	0.70	0.77	0.74	0.86	1.00	1.19

Source: Questionnaire data

The amount of the discounts from the list price tended to increase throughout the period from a low of about nine cents per jug to about 20 cents per jug in Southern Ontario and Metro Toronto. The retail selling price of homo in three quart jugs increased at a slightly faster rate than did the net cost of the product to the retailer in both Metro Toronto and the rest of Southern Ontario.

The list prices of different suppliers tended to be the same within a distribution area. Competitors quickly become aware of changes in each other's bargaining positions and react as their competitive power permits. If a firm is a price leader, that is, if its

prices set the pattern for a region, it may ignore a competitor's change in list prices. If, on the other hand, it is a price follower, it will probably match the price leader's list prices. This is not necessarily evidence of collusion. Customers are quick to make competitors keep published list prices in line with each other even though they may be unaware of discount differences arising through private negotiation.

b) Processors and Distributors

Most processors and distributors, regardless of size, have at least two list prices to distinguish between two categories of customers - wholesale and home delivery. Some have two home delivery list prices, one for urban, the other for rural customers.

The only processors who dictate retail prices to their outlets are those who are vertically integrated with those outlets. These processors may also have a list of transfer prices for "sales" to their company-owned stores. These may be competitive wholesale prices or, on the other hand, may be at intended retail prices. Store gross margins will be accounted for only in the former case.

In addition to wholesale list prices for regular retail outlets, some processors issue food service list prices. These usually reflect contract arrangements with specific customers. They may also have distributors, jobber and dock list prices. The latter offers lower prices to distributors or jobbers who will call for and pick up their milk requirements at the processor's shipping dock, thus eliminating some of the processor's distribution costs.

Those processors and distributors who serve more than one distribution area may have two or three different list prices for each area as well as differing prices within an area. Differences will be justified on the basis of a need to meet local competition or to recover

distribution costs to more distant markets. To accomplish the latter goal, some smaller suppliers often simply add to their list prices a fixed charge per quart delivered beyond a certain distance from their warehouse.

A large vertically integrated organization operating in several distribution areas could therefore have as many as four or five different list prices based on various customer categories with three or four variations based on customer location, making a total of from 12 to 20 list prices. Competitive pressures may dictate that the different lists will not always show different prices for the same commodity.

c) Retailers

Most sales at the retail level are through a store. There are other retail selling modes such as home delivery or through "milk bars" attached to a processing plant. Consideration of home delivery operations is discussed later and milk bar sales are of too little significance in the overall picture to warrant separate treatment.

Most head offices of retail chain stores prescribe selling prices for stores in different marketing areas of the province. Within such an area, store management has some discretion to determine selling prices in relation to local conditions and local competition. Franchise operations follow similar practices. Thus, two nearby stores may have different selling prices for the same fluid milk products. There is greater variation in the selling prices of cream and ice cream than of homo, 2% and skim milk. Yet, even in these products local price differentials are not uncommon.

d) Discounts

A variety of discounts from list price is offered by processors to distributors and retailers and by distribu-

tors to retailers. Nearly all independent retailers who responded said that they received discounts from their processor or distributor supplier. Only a few stores were too small to receive a volume discount.

Five types of list price discounts are in use:

1. Volume - set in relation to the quantity of fluid milk products purchased or expected to be purchased. A graduated scale of percentage discounts is established that increases at specific levels of purchases. The appropriate percentage is applied to the supplier's gross billing for fluid milk products.
2. Flat Rate - a fixed percentage set in relation to units sold, usually under a private brand label, and subject to negotiation.
3. Head Office - set by negotiation between head offices of large suppliers and large chain store organizations. The amount of the discount may not be known to individual branches of the participating companies.
4. "Specials" - promotional allowances offered as incentives to the sale of special packaged products.
5. Cash - set for quick payment of invoices, but reported by only one respondent.

Many of these discounts were paid monthly by cheque, but some processors had systems involving credit to the customer's invoice. One large processor paid independents and retailers both annually and monthly. Food service institutions were often mentioned as recipients of annual rebates.

Instead of being calculated on dollar purchases, a few discounts were related to quantities purchased. Recipients included food service institutions, distributors and home delivery agencies. One processor gave two kinds of volume discounts; one based on unit sales and the other on a technical means of converting the contents of different size packages to a quart equivalent called a "point".

The use of different discounts is illustrated in the multi-market operations of a large processor who might have a four-tiered structure: a volume discount based on dollar sales of a retail franchisee, a smaller discount based on the number of "points" sold, a supplement based on units sold and a house discount negotiated with the head office of the franchiser.

e) Discount Levels

Table 20 shows the average percentage discounts from the list price offered by processors and distributors to their various customers. Competition apparently forces different suppliers to grant equal discounts over a marketing area. Some small processors gave larger discounts than their larger competitors, but the opposite also occurred.

Some small operators and some large vertically integrated operators did not give discounts. However, their net list prices were competitive with others who did.

TABLE 20

AVERAGE PERCENTAGE DISCOUNTS
FROM THE LIST PRICE OFFERED
BY PROCESSORS AND DISTRIBUTORS

	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>
Processors:					
Retail chains	13.1%	14.3%	15.2%	17.7%	18.0%
Independents	5.3	4.3	4.7	5.9	7.9
Distributors	1.6	1.7	1.8	4.3	4.3
Distributors:					
Retail chains	4.6	5.5	6.3	6.6	7.8
Independents	4.7	5.2	5.6	7.2	8.1

Source: Questionnaire data

The average percentage discounts offered to retailers by both processors and distributors increased over the five year period. Retail chain stores received larger discounts than independent stores. This reflected their larger volume of sales. In general, the larger retail chains received the greatest percentage discounts.

While the discounts shown in Table 20 are averages, individual cases fell below or above the levels shown. For example, retail chains are shown as receiving an average discount of 18 percent in 1975. However, the range of actual discounts was from 15 to 24 percent depending upon a customer's sales volume and the supplier's discounting methods.

Several respondents reported unique treatment of an individual valued customer. Retail chains are highly desirable customers because they contract for a comparatively large supply of milk. Volume, higher density of large suppliers in the Southern area and the purchasing power which a chain of stores is able to exert upon its suppliers gains this type of customer the highest percentage discount. Thus in the Toronto/Hamilton/Oshawa area, discounts started to rise in 1973 until by 1975 they averaged 19.5 percent, the highest level in Ontario.

Processor capacity utilization can also be an important factor in modifying discount levels. In the Kingston/Ottawa area higher discount percentages were allowed in the early years, possibly to improve utilization of the three large processing plants in Ottawa.

Similarly, the gap between the higher Northern and the lower Southern area discounts dropped from nine percent in 1971 to six percent in 1975. It may be that a large processor in one Northern town and a smaller one in another had a stable market apportionment between them in relation to their capacities. This could reduce the pressure on these processors to compete by offering larger discounts.

While distributors appear to get the lowest percentage discounts, they are applied to lower wholesale list prices than in the case of retailers. Therefore, the actual cost of product to the distributors in comparison to the cost to retailers is not entirely reflected in the percentage discount figures. The actual net costs to distributors are probably similar to those of retail chains. The highest discounts were in the North where processors may be reluctant to raise prices to the point where distributors would be forced out of business. This would require the processors to assume responsibility for distributing their products, possibly at greater cost than through the present distributor network.

The second part of Table 20 shows that distributors have a different discount structure from the processors. They offer comparable discounts to both chain and independent retailers, in contrast to processors whose chain discounts are almost three times those given to independents. It appears that chains served by distributors are much smaller than those supplied by processors. Their four or five stores do not allow them to press for comparable price advantages. Nevertheless, the average percentage discount given by the distributors increased substantially over the period.

f) House Discounts

House discounts are sufficiently large and poorly understood to require separate discussion. Their importance is reflected in the high average discount figures shown between processors and retail chains in Table 20. These discounts are confidentially negotiated between large multi-market processors and the head offices of these chains. Two examples follow:

Multi-plant processor A gives discounts on gross sales at rates which are negotiated with head offices of

chains. In 1974, one chain store received a house discount of two percent; another received four percent. Head office pays the house discount. The supplying plants also pay volume and other discounts which in 1975 were 18 percent. The additional two and four percent house discounts gave total discounts of 20 and 22 percent to the two chains.

Processor B has since 1972 given discounts on gross sales. In one area of Ontario in 1975 the house discount to the head office of the chain was 9-1/2 percent. The volume discounts to the stores in that area were at 12-1/2 percent, together giving the chain a discount of 22 percent. In another area of the province, the house discount to the same chain was only six percent, while the stores in that area received a volume discount of 16 percent, again giving the chain an overall discount of 22 percent.

There is another form of negotiated discount similar to the house discount. It occurs in the food service contracts negotiated with government institutions and restaurants.

Although this market represents between 9 and 15 percent of fluid milk product sales, the individual customers are quite different so that no pattern or trend in pricing arrangements was apparent. Packaging is in sizes different from those common in retail outlets, being five gallon cartons, creamers and half-pint or eight ounce cartons.

Some contracts are renegotiated frequently, while others may extend for more than a year. Net prices to the smaller food service customers are similar to those for retail chains.

Only three examples of house discounts were reported by smaller independent processors. All serviced one of the stores in a retail chain that received a house discount from a larger supplier. Two gave a house discount of two percent in 1975 which, when added to store discounts of 16.8 and 18 percent, were lower at 18.8 and 20 percent than those given by the large processors. A third small processor deducted a flat \$200 from the customer's monthly billings.

g) Changes in Discount Practices

Other than the upward trend in the discount rate, respondents reported no major alterations in discount practices over the period. One significant special during the period from 1971 to 1974 was the promotion by two suppliers of bagged products through the offer of a 2 cents per unit discount.

h) Other Concessions

Several other types of concessions found can be considered as discounts from the price paid for fluid milk products.

One such concession is provision of point-of-sale advertising material. This probably has a mutually beneficial effect. It assists the retailer to sell the product being advertised and it also increases the sales of that product by the processor. Vertically integrated operations and large processors serving many markets are frequent users of this sales aid. Small operators do not appear to offer this service as much or as often.

Another concession offered to retailers is the free loan of display and storage cabinets. The practice is more common in vertically integrated operations. Occasionally this benefit is extended to franchise operators. One or two small operators reported having to undertake the practice because of competitive necessity,

but in general this practice is not followed by smaller operating units.

Very few respondents mentioned receiving any type of extended credit. Those that did were connected with large or vertically integrated organizations.¹ Companies reporting this concession noted that the rates of interest involved were at current bank rate or above, thus the advantage gained by the retailer was minimal.

Finally, certain delivery practices may allow some processors to offer higher discounts. In most cases deliveries to large retail chain stores are made on pallets dropped at the store's dock area for bulk cooler storage; smaller capacity franchise stores have their deliveries made in a refrigerated storage area. But processors often stock the shelves of small independent stores. Therefore, the quantity that a driver can deliver in an equal time is less for small independent stores and smaller franchise stores than for large retail chains. Distribution costs are proportionately higher to the smaller customers.

¹An analysis of accounts receivable of fluid milk processing plants indicated that the average age was greatest for the large plants and had been increasing for all plants since 1970.

CHAPTER 5

MARGINSa) Calculation of Margins

In this report the term "margin" refers to the difference between the price, net of any discount, which a purchaser pays for a fluid milk product and the price at which that product is sold. Thus a processor's margin is the difference between the net cost of raw milk purchases and the revenue received from the sale of fluid milk products derived from that milk. Similarly, a retailer's margin is the difference between the net cost of purchases of fluid milk products from processors and distributors and receipts from the sale of those products to consumers. The margin realized by the various firms in the marketing system is the amount available to them to cover their operating costs (excluding the cost of milk purchases). If the margin is greater than operating costs the firm realizes a profit.

One of the main objectives of this Inquiry is to determine whether the margins obtained by processors, distributors and retailers of fluid milk in Ontario during the period 1971 to 1975 were reasonable in relation to their operating costs. Reference has been made in the previous chapters to the problems involved in determining precisely the average operating costs of these firms. Further complications arise in estimating average margins at the various levels in the marketing system because of variations from firm to firm in selling prices, in the mix of types of milk sold and package sizes. Because of these variations, different estimates of average margins at the processor, distributor and retailer levels can be derived depending upon the weighting given in the averaging process to these different factors.

In this report two estimates of average margins are provided. It is our opinion that these estimates

reflect the upper and lower range of the "actual" average margins. The margins shown in Table 21 for retailers are based on the difference between the average selling prices reported by the retailers included in the sample and the average selling prices reported by the processors after deducting any discounts. The sample of retailer respondents was heavily weighted by the larger retail chains. The processors' average selling prices were derived by averaging the prices charged by them on their sales to all classes of customers. Thus, the average processor selling price derived in this manner was higher than the average price they charged to their larger customers. Hence the retail margin calculated in this manner was lower than that realized by the larger retail outlets.

The other method of calculating margins is illustrated in Tables 24, 25 and 26. It will be noted that the margins indicated in these tables are higher than those shown in Table 21. For these tables, the average margins for retailers were calculated by subtracting the net cost of milk purchases, as reported by the retailer respondents (predominantly retail chains), from the selling prices which they reported. Since the large retail outlets were able to obtain higher discounts than the smaller stores, the unit cost of their purchases was lower and therefore their margins were higher. Because of the preponderance of the large retail outlets in the sample, the retail margins calculated by this method tend to over-estimate the average margins realized by all retail outlets.

Table 21 shows the weighted average margins for fluid milk sold in Southern and Northern Ontario for the period 1971 to 1975 as reported by the sample of firms included in the Inquiry. The margins shown were calculated by weighting the margins realized by the individual processors, distributors and retailers by their volume of sales of different types of milk (i.e. homo, 2% and skim) in various package sizes.

For Southern Ontario the average margins were calculated for retailers and processors based on sales made directly from processors to retailers, and also for retailers, distributors and processors on sales made through distributors. The former marketing channel is now the predominant one, accounting for about 56 percent of total milk sales. It is the typical channel used by large processors selling to large retail chains and franchised outlets, while the latter is typical of sales to the smaller independent retail outlets.

For Northern Ontario there were not sufficient data available to establish average margins for the processor-distributor-retailer channel, and hence margins are shown only on sales made directly from processor to retailer.

For the purpose of calculating the margins shown in Table 21, it was assumed that the average retail selling price was the same regardless of whether the retailers had purchased their milk directly from the processor or through a distributor. A review of the retail selling prices reported by the retailers in the sample indicated that there was only a slight difference in the average selling price of the two groups. The price paid by processors for their fluid milk supplies is the same to all processors in Southern Ontario. Northern Ontario processors pay 57 cents per cwt more than Southern Ontario processors for their purchases of fluid milk from The Ontario Milk Marketing Board.

Based on the method of calculating average margins as explained above, the data shown in Table 21 indicate that the average retail margin on fluid milk increased from 2.6 cents per quart to 5.8 cents per quart in 1975. This is an increase of 123 percent on milk purchased directly from processors in Southern Ontario. Most of this increase occurred after 1973. In contrast, the average

retail margin on milk purchased by retailers through distributors remained relatively stable from 1971 through 1974. It increased in 1975 to give an increase over the entire period of 23 percent. This channel of distribution accounts for about 12 percent of milk sales as compared with about 56 percent sold directly to retailers from processors. The remainder, 32 percent, is sold to various institutions such as hospitals, schools and eating establishments and by home delivery sales.

The average processors' margin on sales directly to retailers in Southern Ontario increased from 10.4 cents in 1971 to 14.1 cents in 1975 giving an overall increase of 36 percent. The processors' average margin on sales to distributors was considerably smaller (4.2 to 4.7 cents). This is to be expected because distributors perform many of the marketing functions that the processors would otherwise perform on sales made by them directly to retailers.

While the average processors' margin increased at a slower and steadier rate over the period, the average retailers' margin increased substantially in 1974 and 1975. Some of the difference in the timing and rate of these margin increases can be attributed to the Federal Consumer Subsidy on fluid milk. This subsidy was in effect from October 1973 to October 1974 at the rate of five cents per quart. It was phased out completely in two stages by February 1975.

Under this program the major portion of the subsidy funds was directed to milk producers and processors to offset their increased operating costs and reduce the need to raise their selling prices.

TABLE 21

SUMMARY OF WEIGHTED AVERAGE PRODUCT COSTS, SELLING PRICES AND MARGINS OF PROCESSORS, DISTRIBUTORS AND RETAILERS FOR HOMO, 2% AND SKIM MILK COMBINED IN SOUTHERN AND NORTHERN ONTARIO, 1971 TO 1975

SOUTHERN ONTARIO	1971	1972	1973	1974	1975	Per cent Increase 1971-75
	- cents per quart -					
<u>PROCESSOR TO RETAILER</u>						
Retail Selling Price	30.4	30.1	33.1	43.9	50.7	66.8
Retail Product Cost	27.8	27.9	30.2	38.9	44.9	61.8
Retail Margin	2.6	2.2	2.9	5.0	5.8	123.1
Processor Selling Price	27.8	27.9	30.2	38.9	44.9	61.8
Processor Product Cost	17.4	17.5	18.1	26.0	30.8	76.6
Processor Margin	10.4	10.4	12.1	12.9	14.1	35.6
<u>PROCESSOR-DISTRIBUTOR-RETAILER</u>						
Retail Selling Price	30.4	30.1	33.1	43.9	50.7	66.8
Retail Product Cost	27.4	27.3	30.4	41.2	47.0	71.9
Retail Margin	3.0	2.8	2.7	2.7	3.7	23.3
Distributor Selling Price	27.4	27.3	30.4	41.2	47.0	71.9
Distributor Product Cost	21.6	20.8	22.8	30.4	35.0	64.6
Distributor Margin	5.8	6.5	7.6	10.8	11.5	98.3
Processor Selling Price	21.6	20.8	22.8	30.4	35.0	64.6
Processor Product Cost	17.4	17.5	18.1	26.0	30.8	76.6
Processor Margin	4.2	3.3	4.7	4.4	4.7	11.9

TABLE 21 ... continued

NORTHERN ONTARIO	1971	1972	1973	1974	1975	Percent
						Increase
						1971-75
- cents per quart -						
<u>PROCESSOR TO RETAILER</u>						
Retail Selling Price	35.9	36.0	39.1	49.6	56.4	57.1
Retail Product Cost	32.3	30.9	35.5	44.7	50.0	54.8
Retail Margin	3.6	5.1	3.6	4.9	6.4	77.8
Processor Selling Price	32.3	30.9	35.5	44.7	50.0	54.8
Processor Product Cost	18.7	19.0	18.8	26.6	30.9	65.2
Processor Margin	13.6	11.9	16.7	18.1	19.1	40.4

Source: Questionnaire data

Since the operating costs of retailers were also increasing during this period, and since retailers received little direct benefit from the subsidy, one would expect retail margins and prices on fluid milk to increase in line with increases in retail operating costs. However, this was not the case. From December 1973 to June 1975 the average retail margin in Ontario as reported by the survey respondents increased from 2.8 to 5.8 cents per quart. This increase of 107 percent in the average retail margin on fluid milk far exceeded the increase in retail operating costs which occurred during this period.¹

¹An analysis of 16 major Canadian food distributing companies showed that the operating expenses (exclusive of raw material costs) increased by 15.6 percent from 1973 to 1974. Food Prices Review Board. Food Company Profits and Food Prices II, Ottawa, October 1975 p.10

Table 21 indicates that in Northern Ontario retail margins were lower and processor margins higher than in Southern Ontario. While the rates of increase in the processors' margin in Northern and Southern Ontario were similar, the rate of increase in retail margins was considerably lower in Northern Ontario.

Distributors provide a different type of marketing service from either processors or retailers. Table 22 shows the distribution of non-processor-distributor sales according to class of customer.

TABLE 22

NON-PROCESSOR-DISTRIBUTOR FLUID MILK SALES IN
SOUTHERN ONTARIO BY CUSTOMER CATEGORY
BASED ON SALES DOLLARS

	1971	1972	1973	1974	1975
Retail chains of four or more stores	17.3%	17.5%	16.3%	19.3%	21.1%
Company-owned stores	1.4	1.2	1.3	1.5	1.4
Independent stores	31.1	33.2	40.2	39.3	40.4
Retail franchisee	0.0	0.0	0.0	0.0	0.0
Food service (restaurants, institutions, etc.)	11.1	11.4	12.9	13.3	12.0
Distributors or jobbers	1.4	1.4	1.3	1.9	1.1
Home delivery (city or town)	27.6	25.4	19.4	16.8	14.7
Home delivery (country)	9.8	9.2	7.7	6.6	7.2
Other categories	0.3	0.7	0.9	1.3	2.1
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

Independent retail stores and food service establishments have always been major customers of distributors. Home delivery customers accounted for the largest percentage of their sales in 1971, but home delivery service has declined rapidly. However, distributor sales to retail chains has increased from 17 percent in 1971 to 21 percent in 1975. As distributors become more dependent on sales to retail chains, they become subject to competition from processors who sell directly to retailers. Nevertheless, the data shown in Table 21 would indicate that fluid milk distributors in Southern Ontario experienced a steady and substantial

By expressing the margins of the processors, distributors and retailers as a percentage of their respective selling prices, one can observe the relationship between increases in the selling price of the product and increases in margins. For example, as indicated in Table 23, the average margin on fluid milk which was realized by retailers in Southern Ontario who purchased directly from processors increased from about 8 percent of sales in 1971-72 to about 11 percent in 1974-75. On the other hand, the processors' margin on these sales declined from about 37 percent in 1971-72 to less than 33 percent in 1974-75.

TABLE 23

MARGINS AT VARIOUS LEVELS EXPRESSED AS A PERCENTAGE
OF THE RESPECTIVE SELLING PRICES

Southern Ontario

	1971	1972	1973	1974	1975
	- percent -				
sales from processor to retailer					
Retailer	8.5	7.3	8.8	11.4	11.4
Processor	37.4	37.3	40.1	33.2	31.4
sales from processor to distributor to retailer					
Retailer	9.9	9.3	8.2	6.1	7.3
Distributor	21.1	23.8	25.0	26.2	24.5
Processor	19.4	15.9	20.6	14.5	13.4

Northern Ontario

sales from processor to retailer

Retailer	10.0	14.1	9.2	9.9	11.3
Processor	42.1	38.5	47.0	40.5	38.2

Source: Data in Table 21

For milk sold through the processor-distributor channel to retailers, the average retailers' margin expressed as a percentage of retail selling price declined from about 10 percent to 6 to 7 percent during 1974 and 1975. The average processors' margin, expressed as a percentage of their sales to distributors, showed considerable variation. It tended to decrease over the period while the distributors' margin, expressed as a percentage of their selling price, increased between 1971 and 1975.

In Northern Ontario, no distinct trend in the relationship of either the processors' or retailers' average margin to their respective selling prices was apparent.

In the case of sales directly from processor to retailer in Southern Ontario, the relationships described above indicate that through 1974 to mid 1975 retailers were retaining a greater percentage of their sales revenue on milk as margin, whereas the processors supplying them were retaining a smaller percentage of their sales as margin. In other words, over the period under study the margins of these retailers, most of whom would represent large retail outlets, had increased their margins more than their selling prices, whereas the reverse was true for the processors. Hence, by the end of the period these retailers retained more of their sales revenue to cover their operating costs and provide them with a profit than they did at the beginning of the period. The processors retained a smaller proportion of their sales revenue.

The sample of retailers supplied by distributors was heavily weighted by the smaller independent stores. As will be noted in Table 23 their margins expressed as a percentage of sales declined over the period, leaving them with a smaller proportion of their sales revenue to cover operating costs and provide a profit.

b) Variations in Margins by Type of
Milk and Package

In Tables 24, 25 and 26 estimates are given of the average margins obtained by processors, distributors and retailers for different types of milk in various package sizes. However, the method of computing these averages was different from that used to compute the margins shown in Table 21, and consequently the margins indicated in Tables 24, 25 and 26 are greater.¹ Which set of estimates more closely reflects the actual margins is debatable. However, what is important for the purposes of this Inquiry is the trend which has occurred in these margins over the period analyzed. Either set of estimates is useful for this purpose. In addition, Tables 24, 25 and 26 provide information on the trends and relative size of margins on the different types of milk in the various packages.

Table 24 shows the average processor margins on milk sales to retailers in Southern and Northern Ontario by type of milk and container size. From 1971 to the first six months of 1975 the average processors' margin on sales in Southern Ontario rose about 4 to 5 cents per quart for homo milk; for 2% milk about 5 to 6 cents per quart and for skim milk about 7 to 9 cents per quart. In general, the increases in margin per quart of milk on the smaller packages were greater than those on the large containers.

A similar trend occurred in Northern Ontario except that the increases in margin per quart tended to be similar for each type of milk (5 to 8 cents).

In both the North and South substantial increases in processors' margins occurred in 1974 over 1973.

¹See pp. 60-61.

TABLE 24

AVERAGE PROCESSOR MARGINS ON SALES TO RETAILERS IN
NORTHERN AND SOUTHERN ONTARIO BY TYPE OF
MILK AND CONTAINER SIZE

	SOUTH		NORTHERN		NORTH			
	1971	1972	1973	1974	1975*	1973	1974	1975*
- cents per container-								
<u>HOMO</u>								
Gallons	49.0¢	48.3¢	47.8¢	59.5¢	67.8¢	62.1¢	61.7¢	56.7¢
3 quart jug	24.3	23.4	21.5	30.0	35.9	35.6	—	33.1
3 quart bag	29.7	29.2	27.2	35.6	41.6	41.9	40.3	38.9
2 quart carton	25.2	24.8	24.4	29.8	34.5	28.7	28.2	27.5
1 quart carton	13.4	13.1	13.0	15.7	18.2	15.8	15.5	14.2
1 pint carton	9.7	9.5	10.1	11.1	12.6	10.6	9.6	11.1
½ pint carton	5.3	5.2	5.4	6.3	6.8	6.5	5.0	6.3
8 oz. carton	5.3	5.3	5.5	6.0	6.8	5.8	4.7	6.2
<u>2%</u>								
Gallons	53.6	53.5	54.0	65.2	77.9	62.0	60.4	61.2
3 quart jug	26.6	26.5	25.8	34.3	43.2	39.1	—	36.6
3 quart bag	32.1	31.7	31.4	39.8	49.0	44.6	42.4	41.7
2 quart carton	27.5	27.2	27.4	32.8	39.5	30.7	29.6	29.0
1 quart carton	14.5	14.4	14.5	17.1	20.7	16.6	15.9	16.1
1 pint carton	—	—	—	—	—	—	—	—
½ pint carton	5.8	5.8	5.8	6.3	7.4	—	—	—
8 oz. carton	5.3	6.0	6.1	6.3	7.2	—	—	7.0
<u>SKM</u>								
Gallons	61.0	62.1	64.4	78.7	94.8	50.9	—	57.7
3 quart jug	31.1	31.2	32.4	43.2	54.5	39.1	—	33.5
3 quart bag	37.9	38.0	38.8	48.9	60.9	46.5	—	38.1
2 quart carton	29.9	30.1	31.5	38.3	46.1	33.4	—	31.8
1 quart carton	15.7	15.8	16.5	19.8	24.4	14.9	14.0	14.1
1 pint carton	—	—	—	12.5	15.7	—	—	—
½ pint carton	5.9	5.8	6.1	6.9	8.2	—	—	—
8 oz. carton	5.2	5.5	5.8	6.6	7.7	—	—	6.1

Source: Questionnaire data
* Average for six months to June 30

The average margin of non-processor-distributors for the three types of milk in various container sizes is shown in Table 25. Their margins increased from 4 to 7 cents per quart between 1971 and 1975 with the increase in average margin on the two quart carton being at the upper end of that range and on the three quart bag at the lower end.

Throughout the period, distributor margins on the different types of milk and container sizes did not increase uniformly. Between 1971 and 1972 the margins for some products increased while for others it decreased. For some products the major increases occurred between 1972 and 1973, while for others it occurred between 1973 and 1974. This variation in margin increases is probably a reflection of a relatively small sample of non-processor-distributors coupled with major differences that exist between them in size of business, type of customer served and the extent of competition in their individual markets.

TABLE 25

AVERAGE NON-PROCESSOR-DISTRIBUTOR MARGINS BY
TYPE OF MILK AND CONTAINER

	1971	1972	1973	1974	1975*
	-cents -				
HOMO -					
3 quart jug	12.9	15.2	20.2	25.1	26.6
3 quart bag	15.9	17.2	20.2	26.5	28.5
2 quart carton	11.6	10.8	19.5	23.3	25.1
1 quart carton	7.3	7.6	10.5	12.2	12.8
2% -					
3 quart jug	13.2	14.2	21.4	25.7	29.6
3 quart bag	15.8	17.1	20.6	27.2	29.5
2 quart carton	13.1	11.8	20.0	25.1	27.1
1 quart carton	8.6	8.8	11.3	13.2	13.7
SKIM -					
3 quart jug	16.0	15.7	23.5	36.6	38.7
3 quart bag	17.8	19.5	20.2	29.5	28.1
2 quart carton	-	-	-	33.6	24.6
1 quart carton	7.9	7.9	11.3	13.6	14.4

Source: Questionnaire data

* Average for six months to June 30

The average retail margins for Southern Ontario on homo, 2% and skim milk in various container sizes is shown in Table 26.

The sample of retailers in Northern Ontario was not large enough to provide a reliable estimate of the size and trend of retail margins in detail.

The increase in average retail margins in Southern Ontario from 1971 to mid 1975 ranged from 4 to 6 cents per quart for the various types of milk and package sizes. The major portion of that increase occurred between 1973 and 1974.

Throughout the entire period, the average retail margin (per quart) was lower on the three quart jug than any of the other containers. Except for skim milk in 1975, the average retail margin on one quart cartons was the highest of all container sizes.

In general, the average retail margin on homo milk was greater on each type of container than for 2% milk, especially during the latter part of the period. Homo and 2% milk account for roughly equal shares of the market and there is no apparent reason why the costs of retailing one would be greater than the other. On the other hand, skim milk accounts for a much smaller share of the market. Because of this greater retailing costs per unit might be expected. Throughout most of the period under review the data indicate lower retail margins on skim milk than homo or 2%. Thus, these data do not indicate that there is any direct relationship between the costs of retailing various types of milk in different containers and retail margins on those products. It would appear that factors other than the costs directly associated with retailing milk are the dominant determinants of the retail prices of milk and thereby the major determinants of retail margins on milk.

TABLE 26

AVERAGE RETAIL MARGINS BY TYPE OF MILK
AND CONTAINER IN SOUTHERN ONTARIO

	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975*</u>
- cents -					
<u>HOMO</u>					
3 quart jug	11.4	14.1	19.5	25.9	28.7
3 quart bag	14.5	15.5	20.4	27.4	29.2
2 quart carton	9.1	11.2	14.3	15.9	19.5
1 quart carton	4.7	5.8	7.2	8.2	9.9
<u>2%</u>					
3 quart jug	11.2	13.7	18.1	23.4	25.3
3 quart bag	14.7	14.5	19.2	26.9	25.7
2 quart carton	9.0	11.0	14.3	14.5	18.7
1 quart carton	4.6	6.6	7.4	8.1	9.7
<u>SKIM</u>					
3 quart jug	10.6	12.1	17.7	21.0	24.4
3 quart bag	11.6	15.2	19.5	24.6	27.4
2 quart carton	7.8	9.8	13.9	14.7	19.5
1 quart carton	4.4	5.1	6.9	7.2	8.8

Source: Questionnaire data

* Average for six months to June 30

c) Regional Variations in Margins

In the remainder of this chapter variations in average retail margins on fluid milk by regions will be examined. It would be meaningless to compare processors' margins on this basis because most processors serve broad areas of the province. However, we will compare the margins of processors located in Metro Toronto with those located in the rest of Southern Ontario because of the significance of the Metro Toronto market.

As shown in Table 27, the Metro Toronto market consumes almost 30 percent of fluid milk sales in Ontario and over three times as much milk as Northern Ontario. The rest of Southern Ontario (excluding Metro Toronto) accounts for about 62 percent of the province's fluid milk sales.

TABLE 27

DISTRIBUTION OF FLUID MILK PRODUCT SALES BY REGION
- millions of quarts -

Region	1971		1972		1973		1974		1975	
	Quarts	%								
Northern Ontario	63	8.5%	65	8.5%	67	8.6%	69	8.8%	66	8.5%
Southern Ontario (excluding Metro)	458	62.2	477	62.7	489	62.9	489	62.3	477	61.7
Metro	216	29.3	219	28.8	222	28.5	227	28.9	230	29.8
	<u>737</u>	<u>100.0%</u>	<u>761</u>	<u>100.0%</u>	<u>778</u>	<u>100.0%</u>	<u>785</u>	<u>100.0%</u>	<u>773</u>	<u>100.0%</u>

Source: Ontario Ministry of Agriculture and Food. Monthly Dairy Report. Annual Dairy Statistics Nos. 409A, 421A, 432A, 444A, 457A

The Metro Toronto retail stores which were included in the sample were predominantly large retail chains which had a greater revenue per store from milk sales than stores in the rest of Ontario. Because of their scale of operation, one would expect these stores to have lower retailing costs per unit of sales than smaller stores. However, this assumes that the large and small stores provide similar services, but this is not the case. The processors or distributors usually place milk deliveries in the display coolers of the small retailers whereas they merely deliver the order to the receiving dock of the large retail chain. It is also likely that the larger stores would pay higher wage rates and have higher space costs because of their metropolitan locations.

Table 28 presents data on the weighted average processor and retailer margins on fluid milk in Metro Toronto. These average margins were calculated in the same

manner as the margins shown in Tables 24 and 26 and were weighted by container size and volume of sales for each type of milk. It will be noted that the processors' margins in Metro Toronto as shown in Table 28 were somewhat lower than the margins shown in Table 24 for Southern Ontario as a whole. This is the relationship one would expect to find given the large concentrated market for fluid milk in Metro Toronto as compared with the smaller more dispersed markets in the rest of Ontario. These lower margins also likely reflect keen competition among the Metro Toronto processors to capture and retain a greater share of the Metro Toronto market.

TABLE 28

WEIGHTED AVERAGE PROCESSOR AND RETAILER
MARGINS IN METRO TORONTO*

	Dec. 1971	June 1972	Dec. 1972	June 1973	Dec. 1973	June 1974	Dec. 1974	June 1975
- cents per quart -								
Homo								
- Processor	9.2	9.1	8.5	9.0	7.5	6.5	9.2	11.0
- Retailer	4.4	5.1	4.9	5.9	6.5	7.6	9.1	9.7
- Total	13.6	14.2	13.4	14.9	14.0	14.1	18.3	20.7
Partly Skimmed								
- Processor	9.5	9.5	9.0	10.0	8.6	7.9	10.3	13.1
- Retailer	4.4	4.9	4.7	5.5	6.4	7.4	8.8	9.1
- Total	13.9	14.4	13.7	15.5	15.0	15.3	19.1	22.2
Skimmed								
- Processor	13.2	13.3	12.7	14.0	12.6	12.2	14.9	18.7
- Retailer	4.1	4.5	4.3	5.4	5.9	6.8	8.2	8.9
- Total	17.3	17.8	17.0	19.4	18.5	19.0	23.1	27.6
All Fluid Milk**								
- Processor	9.6	9.5	9.0	9.8	8.4	7.6	10.1	12.5
- Retailer	4.3	5.0	4.7	5.7	6.4	7.5	8.9	9.3
- Total	13.9	14.5	13.7	15.5	14.8	15.1	19.0	21.8

Source: Questionnaire data

* Each milk category is a weighted average of sales by volume of three quart jug, three quart bag, two quart carton and one quart carton.

** A weighted average of sales by volume for the three categories.

Comparison of the retail margins shown in Table 28 for Metro Toronto with those shown in Table 26 for Southern Ontario indicates that the margins in Metro Toronto were not lower and in some cases were higher than the average margins in Southern Ontario (including Metro Toronto) despite the fact that retail selling prices in Metro tended to be lower than those in the rest of the province.¹ This would indicate that if retail margins in Metro Toronto were higher than in the rest of Ontario it was due primarily to the ability of Metro retailers to obtain their milk supplies at lower cost. This is illustrated in Table 29.

Table 29 shows average net selling prices charged by processors to retailers in Southern Ontario (excluding Metro), Metro itself and Northern Ontario for each of the three main products in a full range of container sizes. In all cases the North had higher prices than Metro and the rest of the South.

TABLE 29

1975 PROCESSOR NET SELLING PRICES TO RETAILERS
IN QUART EQUIVALENTS

	Southern Ontario (excluding Metro)	Metro	Northern Ontario
<u>HOMO</u>			
3 quart jug	42.4¢	41.7¢	47.6¢
3 quart bag	44.2	44.1	52.6
2 quart carton	47.1	47.2	52.2
1 quart carton	48.4	47.9	53.2
<u>2%</u>			
3 quart jug	41.5	40.8	46.7
3 quart bag	43.5	43.2	51.8
2 quart carton	46.5	46.5	52.2
1 quart carton	47.7	47.1	51.7
<u>SKIM</u>			
3 quart jug	39.3	39.8	42.2
3 quart bag	42.4	41.9	43.8
2 quart carton	45.2	45.0	47.9
1 quart carton	45.9	46.0	47.8

Source: Questionnaire data

¹The retail margin on homo milk in three quart jugs during the period 1972 to 1974 averaged 1.4 cents higher in Metro Toronto than in the rest of Southern Ontario based on data submitted by the sample respondents (Table 19).

During 1975 there was a much greater difference in Northern Ontario between the prices processors charged for skim as compared to homo and 2% than was the case in Metro or the rest of Southern Ontario. Metro prices were generally slightly lower than elsewhere.

The size of processors in the three areas shown in Table 29 may be classified as small within the North, large in Metro and medium in the rest of Southern Ontario. Processor size does not appear to result in different price levels for Metro and the rest of Southern Ontario. However, processors' size and the greater cost of raw milk and higher transportation costs are factors contributing to the higher cost of fluid milk products to retailers in the North.

The Food Prices Review Board conducted an investigation of fluid milk prices in seven major Canadian cities.¹ They reported that the average processor and retail price spread (margin) in Toronto for the period 1972 to 1974 inclusive was 8.9 and 5.9 cents per quart respectively. The data shown in Table 28 for this period provide averages of 9.1 cents for processors and 6.1 cents for retailers; estimates very similar to those obtained by the Food Prices Review Board. On comparing the processor and retail margins in Toronto with those in other Canadian cities, the Food Prices Review Board found that the retail margin on fluid milk in Toronto was relatively high. It was of the opinion that the average retail prices for fluid milk in Toronto supermarkets should have been at least three cents per quart lower during the 1972 to 74 period.²

The findings of this Inquiry have shown that substantial increases in retail margins on fluid milk occurred from 1972 through 1974. Retail margins in Toronto were at least as high if not higher than those in the rest of

¹Food Prices Review Board. Dairy Foods I : Prices, December 1975 p. 21

²Ibid.p. ix

Ontario. These margin increases cannot be justified in terms of concurrent increases in retailers' operating costs. Therefore, we are in agreement with the conclusion reached by the Food Prices Review Board that the retail margins and prices of fluid milk were excessive in Toronto. We are also of the opinion that retail prices and margins were higher than necessary on the average throughout Southern Ontario.

Regional variations in retail prices and retail margins between other cities and distribution areas in Ontario were also compared.¹ The results of this analysis are summarized below. Figures 6, 7 and 8 show retail margins for homo, 2% and skim by distribution or marketing area. The top of the bar on the charts represents the average retail price. The bottom of the bar is the average cost as reported by the retailer. The length of the column reflects the retail margins. Gaps in the charts are caused by a lack of adequate data for a specific location and year.

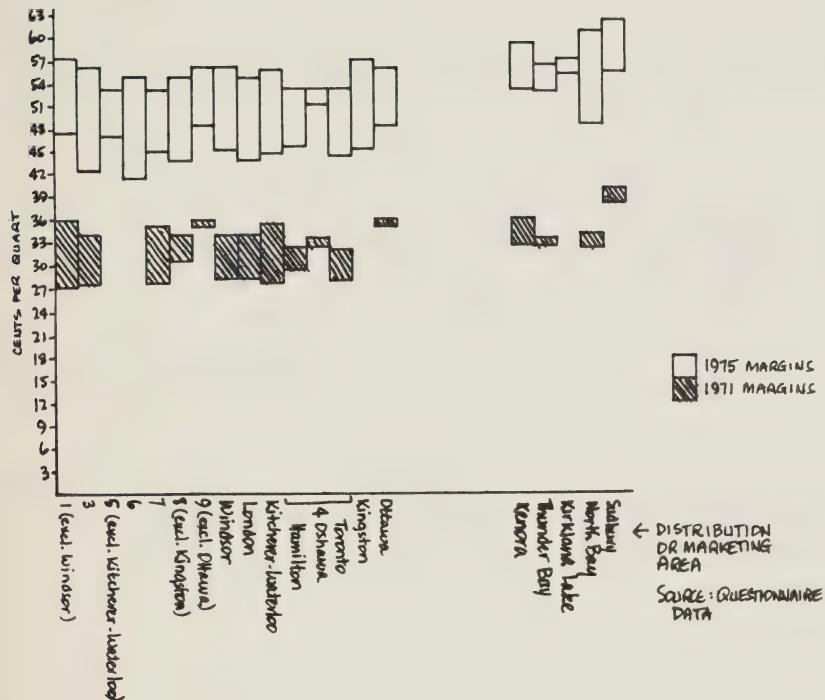
¹See Exhibit 3 for a description of the fluid milk distribution areas in Ontario.

FIGURE 6

RETAIL MARGINS FOR HOMO MILK BY AREA,*
1971 AND 1975

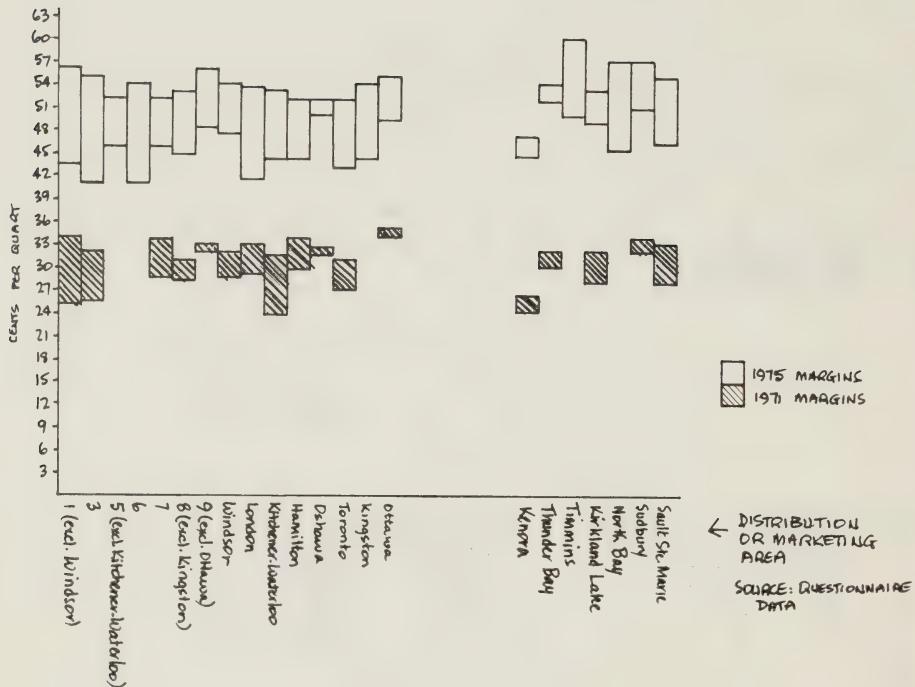
* See Exhibit 3, Distribution areas and districts in Ontario.

FIGURE 7

RETAIL MARGINS FOR 2% MILK BY AREA,*
1971 AND 1975

* See Exhibit 3, Distribution areas and districts in Ontario.

FIGURE 8

RETAIL MARGINS FOR SKIM MILK BY AREA,*
1971 AND 1975

* See Exhibit 3, Distribution areas and districts in Ontario.

A number of changes in the relative selling prices in the areas occurred between 1971 and 1975. The most significant of these was the standardization of prices in Distribution Areas 4, 5 and 7. Distribution Area 4 includes Hamilton, Oshawa and Toronto. Distribution Areas 5 and 7 are the adjacent western and eastern regions oriented around Kitchener-Waterloo and Peterborough respectively.¹ In 1971 Oshawa had consistently higher retail prices than Toronto, but by 1975 this difference had disappeared for all three products.

Another change during the same time was the expansion of margins, at least in absolute terms. Very small margins have largely disappeared, except in the North.

In all areas homo was sold at a higher retail price than 2% and 2% was sold at a higher retail price than skim. The amount of the differential varied by area.

The margins shown in Figures 6, 7 and 8 are for individual products. A retailer's profits, however, result from sales of all products. Figure 9 indicates how the different margins on skim, 2% and homo relate to each other in selected distribution or marketing areas. It is apparent that narrow margins in one product may be offset by wider margins in the others. Since skim usually represents only 5% of all major fluid milk product sales, and 2% and homo share the rest of the market almost equally, a retailer's average margin will be only slightly affected by poor margins on skim milk sales.

¹See Exhibit 3, Distribution areas and districts in Ontario.

FIGURE 9

RETAIL MARGINS FOR ONE QUART OF MILK BY AREA,*
1971 AND 1975

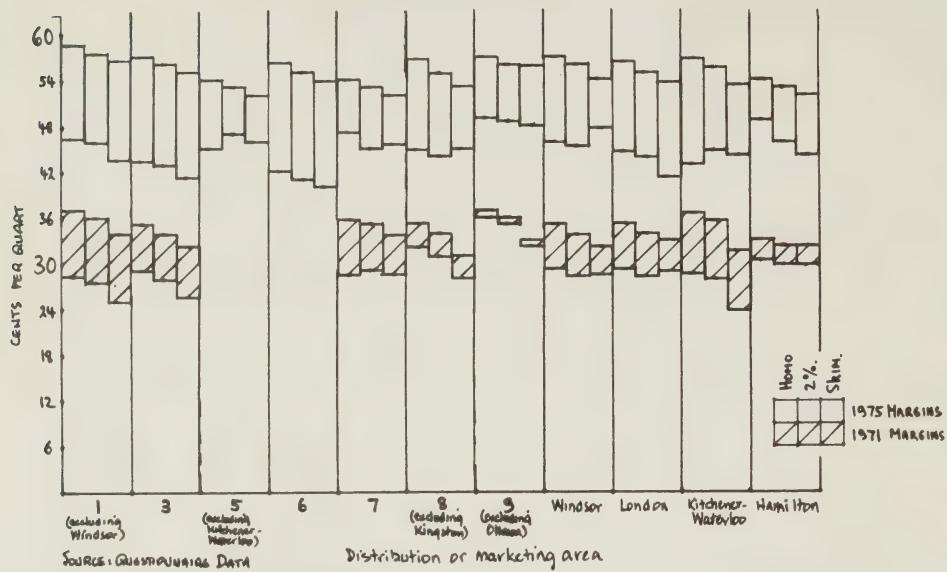
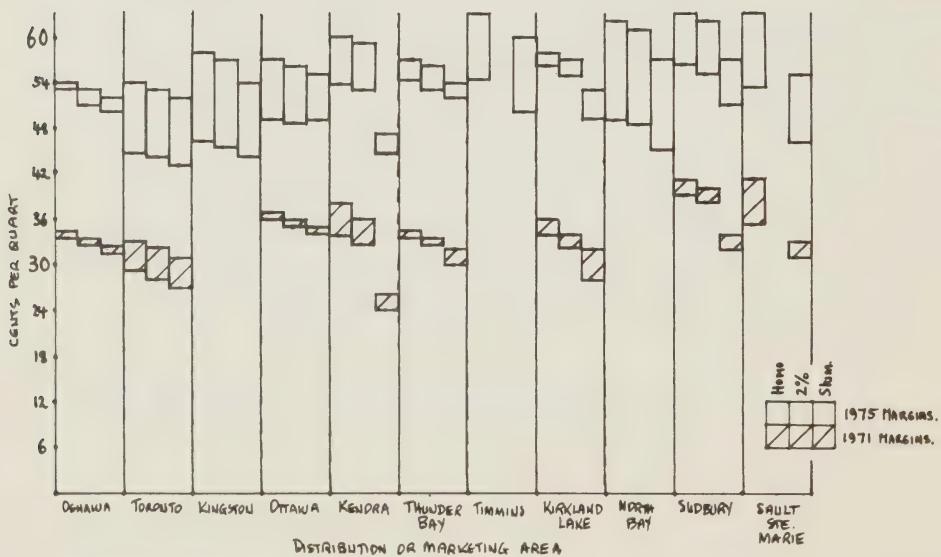


FIGURE 9 ... continued



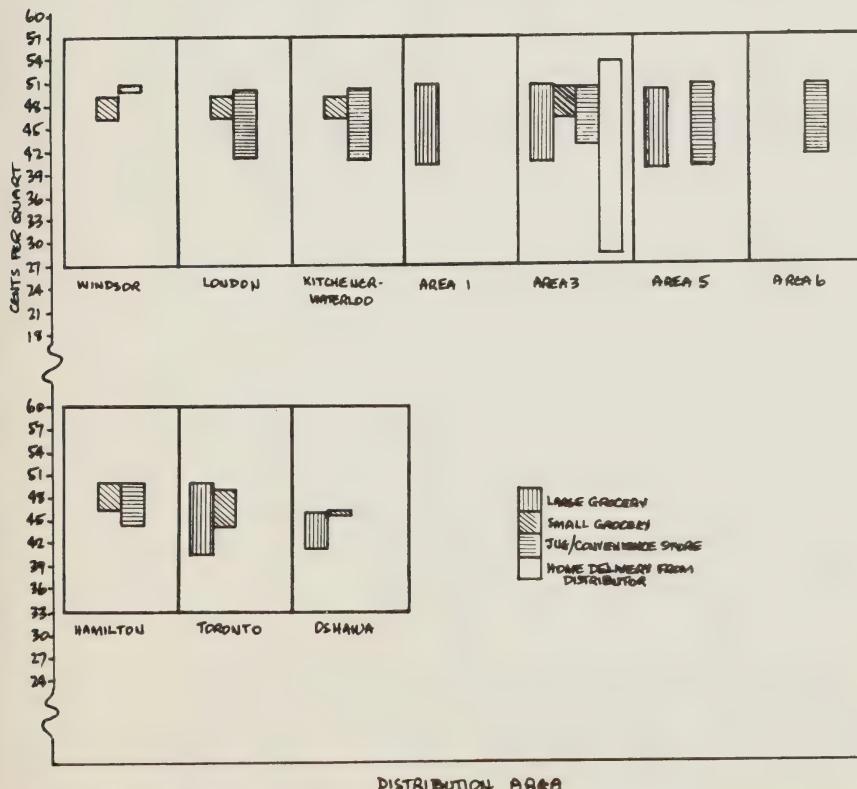
* See Exhibit 3, Distribution areas and districts in Ontario.

d) Type of Retailer

The following discussion analyzes and compares retail margins by type of retailer. For this purpose four types of retailers were identified. These were large grocery stores, small grocery stores, jug milk and convenience stores and home delivery service. Figure 10 presents the data available on this subject. The top of each bar represents the retail price to the consumer and the bottom of the bar is the cost to the retailer as reported for 1975.

FIGURE 10

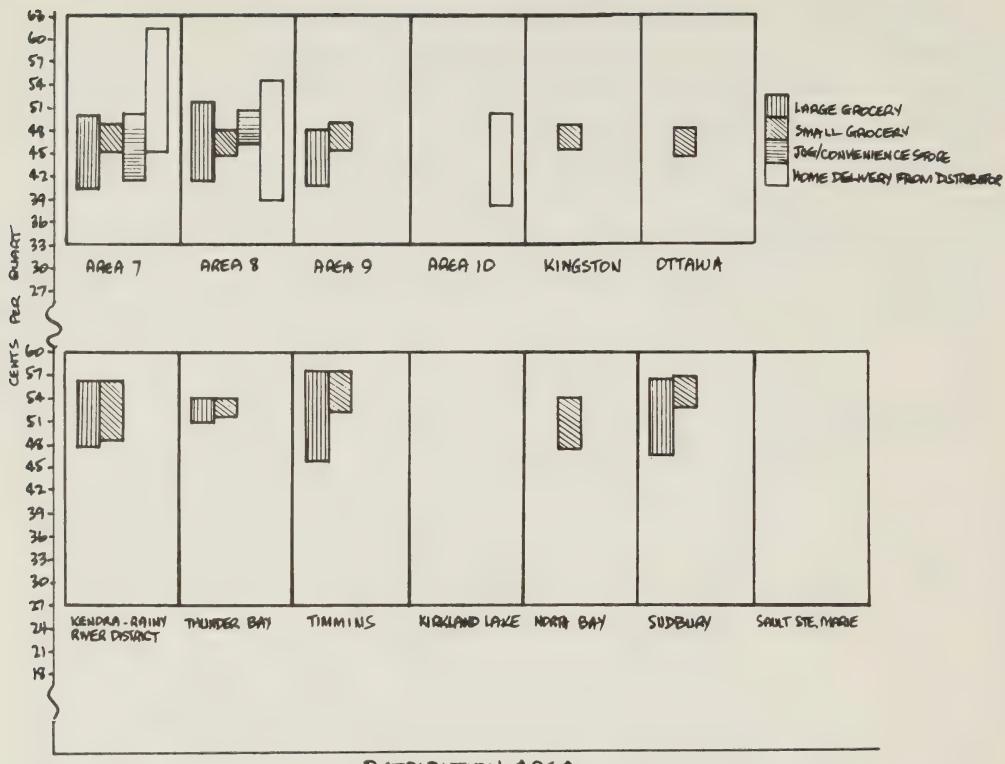
RETAIL MARGINS FOR 2% MILK BY AREA* AND TYPE OF RETAILER, 1975



SOURCE: QUESTIONNAIRE DATA

* See Exhibit 3, Distribution areas and districts in Ontario.

FIGURE 10 ... continued



As might be expected, home delivery sales had the largest margin as the distributor must recover the additional costs of home delivery from his customers. In two distribution areas where comparisons could be made, the distributor's cost was lower than that of two other retailers in the same area. In Distribution Area 7 it was equivalent to the cost of a small grocery store.

The relatively low fluid milk product margins of the small grocery store operators are evident from the chart. Only in Windsor was their average margin greater than that of the jug milk convenience stores. In most cases, their margin was substantially smaller than that of the other

retail outlets. This reflects in all cases a higher cost of product from a supplier. In some cases it was also due to selling at lower prices than their competitors.

Jug milk and convenience stores reported only in the South. Except in Distribution Area 5, their average margins were smaller than those of the large grocery stores. In Distribution Area 8 they were substantially smaller, but in all other areas the average margin of the jug milk and convenience stores was only slightly less than that of the large grocery stores.

In summary, it is apparent that there was a general increase in retail margins on fluid milk between 1971 and 1975. However, the increases were by no means uniform from region to region and market to market across Ontario. Some of the largest increases occurred in the Ottawa and Hamilton markets and in Distribution areas 3, 8 and 9. In 1971, below average margins were reported in Oshawa, Ottawa, Hamilton, Kirkland Lake, Sudbury, Thunder Bay and Distribution Areas 8 and 9 (excluding Ottawa and Kingston). By 1975, very small retail margins in fluid milk were still being maintained in Oshawa, Thunder Bay and Kirkland Lake.

Relatively small retail margins were not confined to these three markets in 1975. In addition below average retail margins were reported in Distribution Area 5 (excluding Kitchener-Waterloo), Area 7 and Area 9 (excluding Ottawa) and in Hamilton and Kenora. Above average margins were reported in Areas 3 and 6 and in London, Kitchener-Waterloo, Kingston and North Bay. There was no apparent relationship between the size of the retail margin in an area and the size or density of its market or its geographical location. This would suggest there are varying degrees of competition in effect in the various markets for fluid milk throughout the province.

Evidence of competition between retailers was apparent by comparing the retail selling prices for fluid milk in Distribution Area 4 (which includes Metro Toronto, Hamilton and Oshawa) with those in the adjacent Distribution Areas 5 and 7. Whereas there was considerable variation in retail prices between these various markets in 1971, this was no longer the case in 1975. However, this did not mean uniformity in retail margins since there was still considerable variability in the prices paid by retailers for their fluid milk supplies. This would suggest that significant differences exist in the relative bargaining strength of retailers vis-a-vis processors and distributors in the various markets.

CHAPTER 6
PROFITS

The results of our analysis of the operating costs and margins of processors, distributors and retailers of fluid milk have been presented in the previous chapters of this report. In this chapter the profit performance of these three sectors of the industry between 1971 and 1975 are compared and evaluated.

Data available from the Inquiry and published data available from other sources regarding the profits of firms processing, distributing and retailing fluid milk are presented. Wherever the data permit, profits are examined in relation to the percentage of sales revenue which they represent and as a percentage of capital employed.¹ Throughout this analysis the profit figures cited refer to profits before taxes and extraordinary items. In general, and particularly for the larger firms, the profits after taxes are deducted would be approximately one-half of the pre-tax profit.

a) Processor Profits

Table 30 presents averages obtained from an analysis of the financial statements of the processors included in the Inquiry sample. It must be remembered that these figures reflect the total profits on total sales of these firms and do not refer to profits earned exclusively on fluid milk. As noted throughout this report, the problems inherent in allocating the costs of a multi-product firm to a specific product or group of products mean that any such estimates are subject to a high degree of variability.

¹Capital employed is the sum of share capital, long term debt, deferred taxes and retained earnings.

TABLE 30

AVERAGE FLUID MILK PROCESSOR PROFITS BEFORE
TAXES AND EXTRAORDINARY ITEMS

	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>
Profits as a percentage of					
a) Capital employed	21.7	21.5	19.4	21.9	*
b) Total sales	4.0	3.9	4.4	4.8	4.9

Source: Questionnaire data

* Insufficient data for valid calculation

When the figures on the ratio of profits to sales shown above are compared with those presented in Figure 3 it will be noted that there are slight differences. In general, however, the magnitude and trend of the two sets of ratios are very similar. The profit estimates given in Figure 3 were calculated by deducting the estimated operating costs involved in processing fluid milk from the revenue derived from its sale. The figures shown above were derived from the financial statements of the processors and therefore reflect the profits realized on either their total dairy division or, in some cases, their total operation. Hence it would be surprising if these two sets of estimates were identical. However, the fact that they were as similar as they are lends credibility to the estimates made of the processors' operating costs and margins.

The data in Table 30 indicate that profits as a percentage of sales increased for fluid milk processors from 1971 to 1975, whereas profits as a percentage of capital employed remained relatively constant. One would expect to find this relationship in an industry where capital was being invested at a more rapid rate than the growth in profits so that the improvement in plant efficiency resulting from the additional investment enabled the industry to lower its operating costs and thereby realize additional profits. This, of course, would

be a desirable development not only from the point of view of the processors. Consumers, in general, would also benefit provided there was sufficient competition in the marketing system to force the processors to pass on some of their gains in efficiency.¹

How large a profit margin has to be before it can be considered excessive is a very complex question. However, it is the opinion of The Milk Commission of Ontario that the profits realized by fluid milk processors in the Province during the period 1971 to 1975 were not unreasonably high. This view appears to be confirmed, in part at least, by a study of food company profits and food prices in 1975.² In this study of the food processing and distribution industries in Canada, the Board analyzed the financial statements of seven dairy product companies, five of whom are large fluid milk processors in Ontario. Three of the five operate fluid milk processing plants outside as well as within Ontario. This study found the average pre-tax profit margin on sales for the seven companies declined from 4.0 percent in 1971 to 3.4 percent in 1972; 3.7 percent in 1973 to 3.3 percent in 1974 compared to an average of 3.6 percent in the period 1964 to 1970. It also found that "firms which are mainly involved in fluid milk processing and packaging currently appear to be less profitable than those which process industrial milk into dairy products such as cheese and skim milk powder".³

¹The data shown in Table 23 indicate that processors' margins as a percentage of their sales revenue decreased from 1971 to 1975. This suggests that processors were passing along at least a portion of their gains in efficiency to their customers.

²Food Prices Review Board. Food Company Profits and Food Prices 11, Ottawa, October 1975 pp. 19-21

³Ibid. p. 21

The rate of return on equity for this group of firms was found to be slightly below the average for the food processing group as a whole. Perhaps the finding of the study which is of greatest significance to this Inquiry was: "The major improvement and leading factor in the stability of the industry's profitability has been a rising turnover ratio. To quote from the Board's profit report of July 1974:

'Indeed, one can say that turnover improvement has been the mainstay of the dairy products industry for the last 10 years'."¹

In commenting further on this improvement the report states: "A productivity advancement can end up as increased profits to the corporation, as increased wages and salaries to the employees, as lower or more slowly rising prices to the customer or any combination of the above. The fact that the customer has benefitted from advancing output per worker is evident. The employees themselves have also benefitted. Wages and salaries per person employed were, in 1974, about two and one half to three times what they were a decade earlier. The industry profit has also benefitted from the situation."²

b) Non-Processor-Distributor Profits

The variation in size of business, markets served, and products handled is much greater among fluid milk distributors than fluid milk processors. The sample of distributors on which this analysis was based was relatively small, hence any averages generated from this sample cannot be considered as necessarily representative of this sector of the fluid milk industry in Ontario.

Table 31 presents a summary of the data obtained pertaining to the profitability of fluid milk distributors. As was the case with the processors, the sale of

¹Ibid. pp. 19-20

²Ibid. p.21

these firms included products other than fluid milk. Thus, the profit ratios shown are not attributable exclusively to milk.

TABLE 31

AVERAGE FLUID MILK NON-PROCESSOR-DISTRIBUTOR PROFITS BEFORE TAXES AND EXTRAORDINARY ITEMS

Profits as a Percentage of	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>
a) Capital employed	13.6	26.6	14.2	*
b) Total sales	0.8	1.2	1.8	*

Source: Questionnaire data

* Insufficient data for valid calculation

Distributor profits before taxes and extraordinary items as a percentage of sales were the lowest of the three levels of the industry but they increased steadily and significantly from 1971. This improvement may be due in part to the declining importance of the costly home delivery part of their businesses and the consolidation of distributor operations which took place during the period under review in this study.

Based on the limited amount of data available, profits of distributors expressed as a percentage of capital employed were very erratic during this period.

c) Food Retailer Profits

As indicated throughout this report, we were unable to provide a reliable estimate of the share of the profits of retailers selling fluid milk that could be attributed to fluid milk sales.

Table 32 shows profits before taxes and extraordinary items as a percentage of all sales (including their sales of fluid milk and all other merchandise) for all retailers and for retail food chain stores. It also

shows retail chain store profits as a percentage of capital employed. The latter statistics were not available for stores other than chain stores.

TABLE 32

AVERAGE FOOD RETAIL CHAIN STORE PROFIT RATIOS BEFORE TAXES AND EXTRAORDINARY ITEMS,
1971 - 1974

	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>
Food Retail Chain Stores Profit as a Percentage of				
a) Capital employed	9.5	12.8	11.5	21.1
b) Total sales	1.5	1.4	1.2	2.5
Average Profit as a Percentage of Total Sales of all Food Retailers	0.6	0.7	1.4	2.1

Source: Questionnaire data

According to the data shown in Table 32, chain food retailers had greater profits in relation to their sales than food retail stores as a whole in three of the four years. Only in 1973 did the latter group, which would include independent as well as chain retail outlets, show a marginally greater profit ratio. This situation may be attributable to the price wars between the major corporate retail food chains which were in effect at that time.

The difference in profits as a percentage of sales between independent retailers and corporate retail chains would be greater than the difference shown in Table 32 between the retail chains and all food retailers. The average profit shown for the latter group includes a large proportion of retail chains. Profits reported by many of the independents were probably overstated because as sole

proprietorships they did not include a salary allowance for the store owner in reporting their expenses.

As a percentage of capital employed these data indicated a substantial growth in profits in food retail chain stores from 1971 to 1974. However, this measure of profitability must be interpreted with caution for any type of business, especially during an inflationary period such as this was. In computing allowances for depreciation the normal accounting practice is to apply a depreciation rate based on the normal life of the asset to its book value or its original cost. In either case, this value will be lower than the replacement cost of the asset if the price (cost) of the asset has risen due to inflation. The net result is that if the depreciation allowances had been sufficiently high to provide the funds necessary to replace the asset at its inflated cost, the total costs would have been higher and therefore profits would have been less.

Unfortunately, there are few published statistics available which can be used to assess the reliability of the estimated profit ratios derived from the sample of retailers included in this study. The most recent statistics published by Statistics Canada on corporation financial ratios are for 1971. They indicate profit ratios before tax on total income and capital employed for all corporate food retailers in Canada in 1971 to be 1.5 and 8.7 percent respectively. This compares to the estimates of retail food chain store ratios by this Inquiry of 1.5 and 9.5 percent.

In its study of food company profits, the Food Prices Review Board analyzed the financial performance of 16 large food distributing companies over the period 1971 to 1974.¹ Eight of these 16 companies have their head offices in Ontario and were included in the sample

¹Food Prices Review Board. Food Company Profits and Food Prices 11, Ottawa, October 1975 pp. 27-28

established for this Inquiry. The Board reported the average pre-tax profit margin on sales for the 16 companies to be 2.2 percent in 1971, 1.5 percent in 1972, 1.7 percent in 1973 and 2.1 percent in 1974. All of these profit margins were lower than the average pre-tax profit margin of these firms of 3.2 percent during the period 1964 to 1970.

Comparing these estimates with those shown in Table 32 for food retail chain stores, it will be noted that the estimates derived from the Inquiry sample are all lower than those reported by the Board except for 1974. However, the differences are not great considering the differences in the two samples.

While it would appear that there was a significant increase in the profit margin of food retailers in 1974 over previous years, there was no evidence to suggest that it had reached an excessive level. This increase still fell far short of the average margin during the late 1960's.

In its analysis of the 16 food distributing companies, the Food Prices Review Board found that from 1973 to 1974 their total sales increased more rapidly than their total costs. As a result, the profit margin rose and almost all of the firms experienced financial gains. In commenting on this situation the Board stated: "It has often been said that the distribution sector has less trouble passing cost increases through the system to end up as higher final prices than other industry groups. It appears to be the case here. This does not indicate an absence of competition -- rather, all distributors are faced with similar cost increases at the same time since inventories are typically relatively low, with the result that they would all tend to pass on these increases as they receive them. Consequently, prices at various retail counters tend to rise by similar amounts."¹ Notwithstanding the fact that between

¹ Ibid. p. 28

1971 and 1975 the average profits of food retailers may not have been unreasonably high, the relatively high retail margins on fluid milk in 1974 and 1975 would suggest that milk sales were making a disproportionately large contribution to food retailers' profits during this period.

PART C

PROVINCIAL PRICING PROCEDURES AND
PRICE LEVELS FOR FLUID MILK

CHAPTER 1

A COMPARISON OF PROVINCIAL
FLUID MILK PRICING PROCEDURES

There are major differences in the degree and extent to which fluid milk prices are established and regulated in the various provinces throughout Canada. A brief outline of the main features of the fluid milk pricing system in each province (excluding Newfoundland) is presented. The price the producer receives for fluid milk is determined by different methods in the various provinces. However, in each case the minimum price is enforced through provincial government regulation. In all provinces except British Columbia and Ontario, government regulation of minimum resale prices of fluid milk was in effect at the wholesale and retail levels in 1975.

In British Columbia a formula based on cost of production and general economic indicators is used to determine the minimum producer price for milk. Monthly adjustments in this price are made on the basis of the formula. The British Columbia Milk Control Board has established a schedule for volume discounts based on the type of store service, the frequency of store drops and the value of sales. Retail sales below cost are prohibited, and a differential exists between home delivery and store prices.

In Alberta¹ a formula using cost of production data has been used since 1974 to determine producer prices. Minimum retail and wholesale prices are established by the Public Utility Board after public hearings at which composite processors' cost statements are presented. Individual statements from each applicant are filed privately with the Public Utility Board. There is no differential between store prices and home delivery prices in Alberta. Wholesale prices are also set, and no volume discounting is allowed for fluid milk. The Alberta Dairy Control Board administers the minimum fluid milk prices established by the Public Utility Board, as well as fluid milk quotas to producers.

In Saskatchewan the Milk Control Board meets with fluid milk processors to establish a retail price of home delivered milk and the wholesale price of milk to stores and institutions. The Milk Control Act and Regulations prevent discounting between processors and retailers. A minimum and maximum price with a two cent spread is set for home delivery. The minimum price applies to store sales while the maximum price is applicable to home delivery. Higher price schedules are established for retail milk in smaller centres outside the major urban areas. Although public hearings were formerly held when price schedules changed, these were discontinued in 1953. Producer prices are determined on the basis of a cost of production formula. The Saskatchewan Milk Control Board also administers fluid milk quotas.

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Detailed information on the control of fluid milk prices in Western Canada can be found in: Parlby, G.B. Control of Fluid Milk Prices in Western Canada 1932-1963, Alberta Department of Agriculture, 1965 and Reschenthaler, G.B. The Performance of Selected Independent Regulatory Commissions in Alberta, Saskatchewan and Manitoba, prepared for the Canadian Consumer Council 1972 pp. 49-109.

In Manitoba a producer price is set on the basis of the cost of production. The maximum retail price for milk is established by the Milk Control Board of Manitoba following public hearings. Retail prices vary in the different marketing regions within the province. Until 1972 the maximum retail price applied to home delivery prices. Since 1972 the maximum price has applied to store prices. The maximum home delivery retail price differential has gradually increased, until at present there is up to a three cent per quart difference on pouch-paks. Retailers are prohibited from selling below cost. No attempt has been made to regulate volume discounting.

In Ontario the authority to determine the price (or prices) producers receive from the sale of milk is delegated to The Ontario Milk Marketing Board under The Milk Act 1965 S.8 (16). The Board uses an economic formula as a guide in establishing the level at which the producer price for milk used for fluid sales will be set. The indices included in this formula provide measures of changes in factors such as farm production costs, consumers' purchasing power, inflation and the relationship of total milk sales to fluid milk sales. Thus, the formula reflects both supply and demand and is not based solely on changes in cost of production.

When The Ontario Milk Marketing Board wishes to change the producer price, it presents its proposed price change to a meeting of the Advisory Committee for Milk. This Committee is made up of eight producers and eight processors. If there is agreement within the Advisory Committee for Milk on the price change, the Board will file a regulation to come into effect either on the first or the sixteenth day of the month stating the new price or prices. If there is no agreement within the Advisory Committee, the representations made by the processor members of the Advisory Committee on behalf of the processing industry are considered by The Ontario Milk

Marketing Board and a decision is made on the amount of the price change. The Board files a regulation with the Ontario Regulation Office, relates its decision to the Ontario Dairy Council and informs all processors affected by letter as to the amount and the effective date of the price change. The Council may decide to appeal the amount of the increase to The Milk Commission of Ontario. The Board endeavours to give at least 30 days' notice of any producer price changes.

If there is no appeal, the proposed price increase goes into effect on a date specified by the Marketing Board.

In the event of an appeal against the proposed price increase, The Milk Commission of Ontario sets a date for the hearing of the appeal. While any person has the right to appeal, the usual appellant has been the Ontario Dairy Council - a trade organization representing the processing industry in the Province. Its interest in this matter stems from the fact that the price of the raw milk accounts for over half of the retail price of fluid milk. Thus, its price directly affects the demand for it and indirectly affects the margin available to processors.

There are no restrictions on the frequency with which the Board may initiate price changes. As a general policy the Board minimizes the frequency of these changes in order to reduce the number of price changes at the retail level. To accomplish this objective, the Board has followed the practice of allowing the existing price to lag behind that indicated by the formula for a period of time. It then establishes a new price which is equivalent to double the difference between the existing price and the formula price. This procedure anticipates that the actual price will be above the formula price half the time and below it half the time.

All processors in Southern Ontario pay the same price for milk used for fluid purposes. In Northern

Ontario the price paid by processors for milk used for fluid sales is 57 cents per cwt higher than the Southern Ontario price.

Retail and wholesale prices are not controlled in Ontario nor are discounting practices subject to any government regulation. Retail price controls on fluid milk were introduced in Ontario in 1933 but were discontinued in 1951. Consequently, differences in the retail price of fluid milk between the various markets in Ontario are a reflection of differences in the costs of servicing them and varying degrees of competition within them.

In Quebec the producer price for Class 1 milk (fluid consumption) is determined by the Agricultural Marketing Board following public hearings. At these hearings the producers' case is represented by the Quebec Federation of Milk Producers. Since 1973 an economic formula has been used as a guide in setting producer prices.

In addition to setting minimum producer prices, the Agricultural Marketing Board also sets minimum and maximum prices at the wholesale and retail level for Class 1 milk. These prices are enforced through Board Orders for each of the market regions and for each regulated container.

In New Brunswick the retail price for fluid milk is established by the New Brunswick Dairy Products Commission on the basis of milk cost formulae applied at both the producer and processor levels. Minimum prices are established in both cases. A price differential exists between wholesale and retail prices with the minimum retail price being set only for home delivered milk. Retail store prices are normally slightly lower than home delivery prices.

Nova Scotia is characterized by price setting at the producer, wholesale and retail level by the Nova Scotia Dairy Commission. In the case of producer prices, a cost

of production formula is used as a guideline. A minimum wholesale price is established which sets the minimum store selling price. Home delivery prices are generally one cent higher than those of chain stores. However, there is considerable variation in retail prices depending on the type of outlet and the area.

In Prince Edward Island the price is controlled at the producer, wholesale and retail levels. Three formulae are used to set a minimum price for each of the sectors. Minimum prices are established in all cases, with the retail price being set on the basis of home delivery. Producers and processors present briefs to the Commission whenever price increases are being considered.

CHAPTER 2

INTERPROVINCIAL COMPARISON OF MILK PRICES

In view of the considerable variation among provinces in the procedures used to regulate and control fluid milk prices at the producer level and at subsequent stages in the marketing system, the question arises concerning the effect these different procedures have on the ultimate retail price and the margins realized by processors and retailers.

The Food Prices Review Board conducted a study of fluid milk prices and price spreads covering the period 1972 to 74 in seven major Canadian cities.¹ A summary of the prices and price spreads as determined by this study is shown in Table 33.²

According to this study, the average retail price for fluid milk in Toronto (34.8 cents per quart) was below the weighted average price for the seven cities (35.2 cents) and was only slightly higher than that in Montreal (34.1 cents). The price paid by processors in Toronto was below the seven city average. However, the processor price spread (margin) in Toronto was substantially below the processor margins in the other cities while the retail margin was considerably greater. In commenting on these findings the Food Prices Review Board stated: "These (in Toronto) retail price margins for fluid milk were the highest of all seven cities surveyed, and exceeded those in the city having the next highest retail price margins by more than three cents per quart. There was no evidence to indicate higher retail costs in Toronto. Therefore, the Food Prices Review Board recommends that supermarkets reduce their price spreads for fluid milk.

¹ See Food Prices Review Board. Dairy Foods 1 : Prices, Ottawa, December 1975.

² Ibid. Table 5, p.21

On the basis of the analysis of data for 1972 - 74, average retail prices for fluid milk in those stores should have been at least three cents per quart lower.¹

TABLE 33

FLUID MILK PRICES AND PRICE SPREADS, 1972-74 AVERAGE

	Producer Price	Processor Price Spread*	Wholesale Price (cents per quart)	Retail Price Spread	Total Price**	Farm-Retail Price Spread
Vancouver	23.1	12.9	36.0	2.9	38.9	15.9
Calgary	18.4	14.9	33.3	1.6	34.8	16.5
Regina	18.7	15.4	34.1	1.5	35.6	16.9
Winnipeg	19.2	13.3	32.5	2.3	34.8	13.7
Toronto	19.9	8.9	28.8	5.9	34.8	14.9
Montreal	19.9	11.4	31.3	2.6	34.1	14.2
Halifax	21.5	15.9	37.4	1.4	38.8	17.6
Canada ***	20.2	11.3	31.5	3.7	35.2	15.0

Source: Food Prices Review Board. Dairy Foods I : Prices, Ottawa, December 1975, p.21.

* The wide variation in processor price spreads is a strong indication that their level may well be higher than necessary in some cities. In some cases this may be a direct result of regulated minimum wholesale prices. The differences between Montreal and Toronto, two cities of comparable size, are particularly striking. In Montreal, minimum wholesale prices are "set", in Toronto they are not.

** Totals may not add due to rounding. Includes retail price plus federal subsidy.

*** Seven-city weighted average.

A comprehensive and detailed analysis of fluid milk prices and margins in each of the Canadian provinces was beyond the scope of this Inquiry. However, an attempt was made through correspondence and personal interview with the appropriate provincial milk control agencies to ascertain the average producer, wholesale and retail prices at which standard milk was sold during 1975. A summary of these data is presented in Table 34.

It must be emphasized that because of the many differences in the manner in which fluid milk is priced, processed, packaged and distributed in the provinces it is extremely difficult to obtain price and margin data

¹Ibid. page ix.

that are completely comparable. For all provinces except Ontario the retail price shown is the price of homo milk in the one quart paper carton during the period from mid September to mid October 1975. In Manitoba and Saskatchewan the prices given refer to prices in Winnipeg and Regina respectively. In the other provinces where retail price controls were in effect, the price quoted extended over a larger area. For Ontario the retail price shown is based on the average price per quart paper containers of homo milk in Southern Ontario in June 1975 as reported to the Inquiry by retailers. The producer prices and processor and retailer margins shown for Ontario are those estimated by the Inquiry for Southern Ontario. Various provincial agencies reported the prices for the other regions.

TABLE 34

ESTIMATED PRICES AND MARGINS FOR HOMO MILK IN
ONE QUART PAPER CONTAINERS BY PROVINCES, 1975*

<u>Province</u>	<u>Producer Price</u> - cents per quart -	<u>Processor Margin</u>	<u>Retail Margin</u>	<u>Retail Price</u>
B.C.	36.9	20.1	5.0	62.0
Alta.	30.5	21.5	*	52.0
Sask.	30.4	21.1	1.5	53.0
Man.	31.0	18.2	1.8	51.0
Ont.	31.0	18.2	6.9	56.1
Que.	31.5	15.0	5.5	52.0
N.S.	31.4	23.6	3.0	58.0
- percent of retail price -				
B.C.	59.5	32.4	8.1	100.0
Alta.	58.7	41.3	**	100.0
Sask.	57.3	39.8	2.8	100.0
Man.	60.8	35.7	3.5	100.0
Ont.	55.3	32.4	12.3	100.0
Que.	60.6	28.8	10.6	100.0
N.S.	54.1	40.7	5.2	100.0

* Data were estimated from information provided by milk control authorities in the various provinces. In some cases, adjustments were made to provide a more uniform treatment of the way in which prices and margins were calculated.

** Alberta data did not provide a breakdown of processor and retailer margins.

In considering the processor and retail margins in Table 34, one should bear in mind the difficulties inherent in obtaining comparable data from each province. However, the prices producers receive for fluid milk are reasonably uniform within each province and thus less subject to error. Each province also collects statistics on a regular basis of the retail prices of fluid milk.

The producer price in Ontario in 1975 was slightly below the average of the other provinces, while the retail price was among the highest. The result was one of the largest marketing margins of all the provinces. Since the processors' margins were relatively low, the high marketing margin was attributable to an exceptionally high retail margin. While the data shown in Table 34 provide only partial evidence of processor and retailer margins on fluid milk in Ontario, they do conform with the conclusion reached by the Food Prices Review Board that retail margins on fluid milk in Metro Toronto were excessively large.

CHAPTER 3
PRICE CONTROLS

As noted previously eight provinces in Canada exercise some form of government regulation over the retail and/or wholesale price of fluid milk. In view of the evidence indicating that the retail prices and margins in Ontario were relatively high in 1975, a consideration of the desirability of introducing some form of price control would be appropriate. The purpose of this chapter is to evaluate the implications of this type of regulation.

Prior to 1934 there was virtually no government regulation of the fluid milk industry in Ontario. During the depression years of the early 1930's price cutting by fluid milk distributors became rampant with fluid milk being retailed for as little as five cents per quart. This resulted in widespread bankruptcy among distributors which left many producers without markets and with little chance of being paid. To cope with this chaotic situation the Government of Ontario introduced the Milk Control Act in 1934. It established a Milk Control Board with broad regulatory powers including the authority to regulate consumer and producer prices of fluid milk. Thus, retail price control was in effect in Ontario from 1934 until it was discontinued by an amendment to the Milk Control Act in 1947-48.

In 1946 Mr. Justice Dalton C. Wells was appointed to conduct a Royal Commission to inquire into the producing, processing, distributing, transporting and marketing of milk in Ontario. In the course of its investigations the Commission examined the effect of retail price controls and concluded that "the price of fluid milk at the consumer level be not agreed to or fixed in ordinary circumstances and that the power should be a corrective one only ..." ¹

¹ Ontario. Royal Commission on Milk Report, 1947. Toronto p.149

In commenting on the effects of the controls exercised under the Milk Control Act 1934 the Commission stated: "The effect of the operation of the Milk Control Act since 1934 has been to remove most of the competitive pressures which ordinarily operate in respect of private business. In doing this, it has not substituted that full measure of public control which would seem to be the necessary alternative. In the result, therefore, particularly under inflationary or semi-inflationary conditions, the consumer has suffered. Instead of having the benefits of the operation of one principle or the other in the industry, the general public, in my view, have had some of the worst results of both."¹

The Commission went on to recommend that the Milk Control Board should "undertake a continuous collection and study of the cost and profit position of distributors"² and that such additions to the staff of the Milk Control Board as are necessary to carry out this function be considered. With respect to the retail price of fluid milk the Commission further recommended that the power of the Board be made clear to enable it ultimately to determine the price to consumers if the prices obtained are against the public interest. However, the Commission qualified this recommendation with the proviso that this power should be viewed as a corrective one only and that the price of fluid milk at the consumer level should not be "agreed to or fixed in ordinary circumstances."³

There can be little, if any, disagreement with the general premise that consumer prices for fluid milk which are unreasonably high in relation to the costs and normal profits of the businesses engaged in producing, processing, distributing and retailing the product are contrary to the

¹ Ibid. p. ix

² Ibid. p. 148

³ Ibid. p. xi

public interest. If such a situation occurs it reflects a lack of effective competition in the marketing system and signals the need for some form of corrective action. However, achieving a solution to the problem raises several critical questions.

What types of intervention are likely to be most effective and how effective is each likely to be? What will be the costs involved in each type of intervention in relation to its benefits in both the short and long term?

One of the short term advantages of retail price control is that it gives the appearance that something is being done. This feature is particularly attractive to the public, especially during periods of inflation when the prices of food are increasing rapidly. The Federal subsidy on fluid milk which was in effect from October 1973 to February 1975 undoubtedly retarded retail price increases during this period. However, following removal of the subsidy the retail price of milk advanced at an accelerated rate. Unless price controls are considered to be a permanent feature of the system, any benefits realized during the period of control may be nullified by the destabilizing effects when the controls are removed.

An argument sometimes advanced in support of price controls is that it would serve as a means of controlling the practice of volume discounting. Disregarding for the moment the question of whether this practice should be curbed, it is improbable that controls on wholesale and retail prices would be an effective means of curtailing the practice. The cost involved in providing sufficient staff to audit adequately the sales of all processors and distributors and enforce the regulations would be substantial. Even so, regulated firms could probably devise alternative means of evading the intent of the controls.

Much has been written on the subject of price controls by regulatory agencies. The following observations seem particularly relevant to the fluid milk industry in Ontario.

If the regulatory body is responsible for controlling prices it must make judgments from time to time as to what the price should be. Under a regime of price control the normal indicators of what the price would be under competitive market conditions would no longer be available to the regulatory agency. The agency would be forced to rely on interpreting data relating to the costs and profits of the firms involved in the industry.

Reschenthaler¹ observed that the regulatory authorities in the Prairie Provinces often do not have reliable indices of economic performance for making their pricing decisions. Even if adequate information were available the pricing authority must try to establish a price which would generate a sufficient supply of the product. Since the individual firms will vary in terms of size and efficiency the result, according to Mr. Justice Wells, will be that: "if a consumer's price is fixed it must be one which may well result in a profit to the large distributor entirely out of proportion to that enjoyed by the smaller distributor."²

At the public hearings in Toronto, Frank M. Warnock of Dominion Dairies made the statement that if the company wanted to maximize profits on milk they would favour the introduction of retail price controls.

Evidence from the literature has one common theme, namely, that retail price controls create an entirely

¹Reschenthaler, G.B. The Performance of Selected Independent Regulatory Commissions in Alberta, Saskatchewan and Manitoba, prepared for the Canadian Consumer Council, 1972 p.104

²Ontario. Royal Commission on Milk Report, 1947 p.108

new series of problems. For example, Roland Bartlett,¹ observed that in comparing markets with and without retail price controls, those markets with controls were characterized by higher gross margins. Jacobson² observed that new developments within the industry tend to create new opposition to controls and present an increasingly complex series of problems for milk control agencies. Both Christensen³ and Groves⁴ in separate presentations indicated that where controls existed a greater degree of vertical integration between processors and retailers occurred because of the profit umbrella provided under price control.

In the Canadian context, Clark et al⁵ in a background paper on dairy policy recommended that provincial governments should not attempt to set margins for processors or distributors through administered pricing. Reschenthaler⁶ commented that under the system of retail price controls in existence in Western Canada, the consumers were the big

¹ Bartlett, R.W. "Are Supermarkets Charging too Much for Handling Milk", Illinois Agricultural Economics July 1973 p.5

² Jacobson, R. "New Developments in Wholesale Distribution", paper presented at the 32nd Annual Meeting, International Association of Milk Control Agencies, Milwaukee, Wisconsin, 1968 p.82

³ Christensen, S.K. "Attitudes Toward Milk Control", paper presented at the 29th Annual Meeting, International Association of Milk Control Agencies, Banff, Alberta 1965 p.71

⁴ Groves, F.W. "Vertical Integration in the Fluid Milk Industry", paper presented at the 31st Annual Meeting, International Association of Milk Control Agencies, Biloxi, Mississippi, 1967 p.77

⁵ Clark, J.H. et al. Canadian Dairy Policy : A Report to the Federal Task Force on Agriculture, Department of Agricultural Economics, University of Guelph, 1969 p.144

⁶ Reschenthaler, G.B. pp. 104-106

losers. Allan¹ noted that since the elimination of retail price controls in Ontario there has been a great deal of competition in terms of new products and package types. Finally, the Food Prices Review Board recommended that: "the establishment of minimum wholesale prices for fluid milk by some provincial agencies is a practice that should be discontinued."²

Given these assessments of the effects of price controls in various milk markets, we are of the opinion that price controls will not provide significant long term benefits to the consumer. If any group is to benefit it would likely be the larger more efficient processing and retailing firms which would, under the umbrella of price controls, realize higher profits than they would under a more freely competitive market. Indeed, the consumers are likely to be worse off because desirable technological improvements in the processing and retailing sectors could be retarded by the absence of effective competition.

If there is evidence that one or more sectors of the fluid milk industry are consistently charging prices which are unreasonable in relation to their costs and normal profit expectations, it is the responsibility of the provincial government to take appropriate action to protect the public interest. Careful monitoring of changes in prices, costs and profits coupled with public disclosure, if necessary, of any excesses could have a salutary effect. Experiences indicate that price controls on fluid milk are not an effective mechanism for protecting the long term interest of the consumer. Price controls should be used only as a temporary measure in exceptional circumstances.

¹Allan, D. "Concentration and Competition in Ontario's Fluid Milk Industry", Ontario Economic Review November 1965 p.11

²Food Prices Review Board. Dairy Foods I : Prices, Ottawa, December 1975 p. ix

PART D
EXHIBITS

EXHIBIT 1

COMPOSITION AND FUNCTION OF
THE MILK COMMISSION OF ONTARIO

The Milk Commission of Ontario is a government body appointed by the Lieutenant Governor in Council and responsible to the Minister of Agriculture and Food.

The duties and responsibilities of the Commission are listed in The Milk Act (Sec. 4) as follows:

- to exercise such powers as are conferred upon it by or under this Act;
- to develop and formulate policies to stimulate and improve the marketing of milk and milk products;
- to select, develop and maintain research programs required for policy development and formulation;
- to inquire into the efficiency of such policies and the manner in which they are being implemented;
- to co-operate with the Canadian Dairy Commission or any other agency of Canada or of any province of Canada respecting the producing, processing and marketing of milk and milk products;
- to provide and maintain liaison with organizations representing producers, processors or transporters in Ontario; and
- to conduct such studies as the Minister directs respecting the producing, processing and marketing of milk or milk products, and report thereon to the Minister.

EXHIBIT 2

LIST OF PUBLIC HEARINGS AND BRIEFS SUBMITTED

PUBLIC HEARINGS

Sault Ste. Marie	July 8, 1975
London	July 9, 1975
Kingston	July 17, 1975
Toronto	July 23, 1975
	July 24, 1975

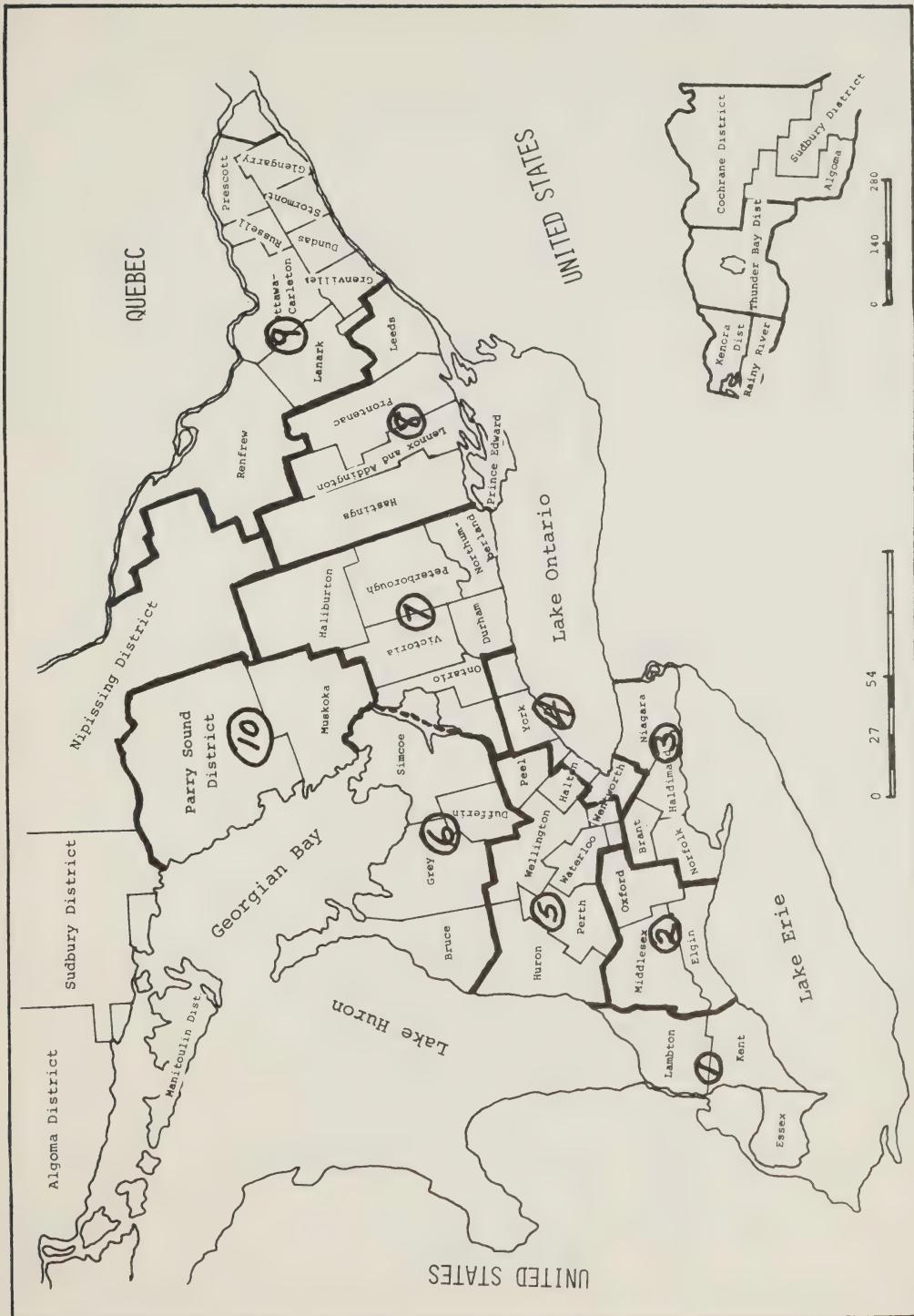
BRIEFS SUBMITTED

BRIEF #	NAME	ADDRESS
1	Chas. D. Clark	Box 187, Whitney, Ontario
2	Mrs. J. Rees	88 Argyle Ave., Hamilton, Ontario
3	Mr. A.G. Peckham	Town & Country Ct. 6400 Huggins St. Apt. 509 Niagara Falls, Ont.
4	Dorothy Gordon	147 Audrey Avenue, Scarborough, Ont.
5	J.K. Steele	507 Riverdale Ave., Apt. 318, Ottawa
6	Bernie M. Cusack	87 John Street, Orangeville, Ont. (Quality Park Vending Co. Ltd.)
7	Mrs. J. Mingiardi	56 Rosewood Dr., Kitchener, Ontario
8	Mr. Maurice Johnson	R.R. 2, Caledonia, Ontario
9	Mr. Clifford Baldwin	29 Tweedsmuir Ave. W., Chatham, Ontario
10	Mrs. I. Schaadel	Box 17, Madsen, Ontario
11	Mr. Gordon D. Reekie	Retail, W'sale, Dairy & Gen. Workers' Union, Ste. 308, 15 Gervais Drive, Don Mills, Ont.
12	Mrs. M.J. Murphy	181 Craigyston Road, Hamilton, Ont.
13	Mrs. Margaret Rouble	Pres., Women Against Soaring Prices, 121 Humber Blvd., Apt. 915, Toronto 9, Ont.
14	Mr. J.D. Archer	Mgr., Archers Dairy Ltd., Box 445, Kirkland Lake, Ontario.
15	Harriet L. Hershey, Pres., Algoma Branch	Consumers' Association of Canada (Ontario), 191 Meadow Park Crescent, Sault Ste. Marie
16	Mrs. Myrna Inglis, Committee Chairman	Joint Purchasing & Food Service Committee, Region 3, Ontario Hospital Association
17	Oscar Thompson	34 Water St. W., Apt. 103, Napanee, Ont.
18	Mrs. Rosemary Fournier	84 Queensline Drive, Ottawa, Ontario

EXHIBIT 2 continued

BRIEF #	NAME	ADDRESS
19	John Coutts	R.R. 1, Elmwood, Ontario
20	Mrs. Helen Coran	Fort Frances Development Commission, 259 Scott St., Fort Frances, Ontario
21	Donna Gordon	1163 Maureen Crescent, Sudbury, Ontario
22	Duane L. Buchanan	431 Chambers Avenue, Sault Ste. Marie, Ont.
23	Clarence S. Dungey, National Rep.	C.U.P.E., 240 McNabb Street, 3rd Floor, Sault Ste. Marie
24	C.A.C. (Ontario)	2 College St., Toronto. M5G 1K3
25	Mrs. R. Jackson	1881 Huron St., P.O. Box 5154, London
26	Kemp Products Limited, Paul G. Kemp W. Allen	Cardinal, Ontario
27	Mrs. M. Dasselaar	4526 Morrison St., Niagara Falls, Ontario
28	Stuart A. Thiesson Executive Secretary	National Farmers Union, 250C - 2nd Avenue South, Saskatoon, Sask.
29	Mrs. Renus Bailey	Sunrise Dairy, Josephine Street, Wingham, Ontario
30	W. Stewart, Ontario Leader	Communist Party of Canada, Ont. Committee, Room 11, 24 Cecil Street, Toronto 130, Ont.
31	Mrs. Joyce Dowling Sec.Treas. Local 316	National Farmers Union R.R. #4, Gananoque, Ontario.
32	Andrew Kittmer	Local 341, District 5, Region 3, National Farmers' Union
33	William Elgie	Model Dairy (Sault) Limited and Soo Dairies Limited
34	Wm. Sagain, Pres.	Silverwood Dairies Limited 6205 Airport Road, Mississauga, Ont.
35	Alastair Smith	Retail Council of Canada 74 Victoria Park Ave., Weston, Ont.
36	Mr. R.M. Binnington President	Beatrice Foods (Ontario) Limited, 1155 Division Street, Kingston, Ont.
37	Mr. Warren Caulfield	Borden Company, Limited, 1275 Lawrence Ave. E., Toronto
38	Mr. Paul Pickett	Retail Merchants Assoç. of Canada Inc., 1780 Birchmount Road, Scarborough, Ont.
39	Mr. A.P. Graham Vice Pres. & Gen. Mgr.	Ont. Food Div., The Oshawa Group Ltd., 125 The Queensway, Toronto, Ontario
40	Mr. Frank Warnock	Dominion Dairies Limited, 235 Walmer Road, Toronto, Ontario
41	Mr. Norman M. Knebel	Canada Safeway Limited, Toronto Division
42	Mr. F. Redelmeier	The Ontario Milk Marketing Board
43	Mr. Walter Miller	National Farmers Union, Region 3
44	Mr. David Woods	Pollution Probe, University of Toronto
45	Mr. Leo R. Robbins, President	The North Side Dairy Limited, 871 Niagara St., Welland, Ontario

EXHIBIT 3
DISTRIBUTION AREAS AND DISTRICTS IN ONTARIO



Area 1 – The Counties of Essex, Kent and Lambton.

Area 2 – The Counties of Elgin, Middlesex and Oxford.

Area 3 – The Counties of Haldimand, Lincoln, Norfolk and Brant County except the Township of Dumfries.

Area 4 – Comprises (A) The Towns of Burlington and Oakville in the County of Halton.

(B) The Townships of East Whitchurch, Pickering and Whitchurch in the County of Ontario.

(C) The Townships of Toronto and Toronto Gore in the County of Peel.

(D) The County of Wentworth except the Township of Beverly.

(E) The County of York except the Townships of East Gwillimbury, Georgina, King, North Gwillimbury and Whitchurch.

Area 5 – Comprises (A) The Township of South Dumfries in Brant County.

(B) The County of Halton except the Towns of Burlington and Oakville.

(C) The County of Peel except the Townships of Toronto and Toronto Gore. (E) The Township of Beverly in the County of Wentworth.

Area 6 – The Counties of Bruce, Dufferin, Grey and Simcoe.

Area 7 – Comprises (A) The Counties of Durham, Peterborough, Northumberland and Victoria, and the Provisional County of Haliburton.

(B) The County of Ontario except the Townships of East Whitchurch, Pickering and Whitchurch in the County of York.

(C) The Townships of East Gwillimbury, Georgina, King, North Gwillimbury and Whitchurch in the County of York.

Area 8 – Comprises (A) Counties of Frontenac, Hastings, Lennox and Addington and Prince Edward.

(B) County of Leeds except the Townships of Kitley and South Emsley.

Area 9 – Comprises (A) The Counties of Carleton, Dundas, Glengarry, Grenville, Lanark, Prescott, Renfrew, Russell and Stormont.

(B) The Townships of Kitley and South Emsley in Leeds County.

Area 10 – Comprises (A) Territorial District of Muskoka.

(B) Territorial District of Parry Sound except the Geographic Township of North Hinsworth..

Northern District comprises the Districts of Cochrane, Algoma, Sudbury, Timiskaming and Nipissing.

EXHIBIT 4
LOCATION OF FLUID MILK PROCESSING PLANTS IN ONTARIO IN 1974

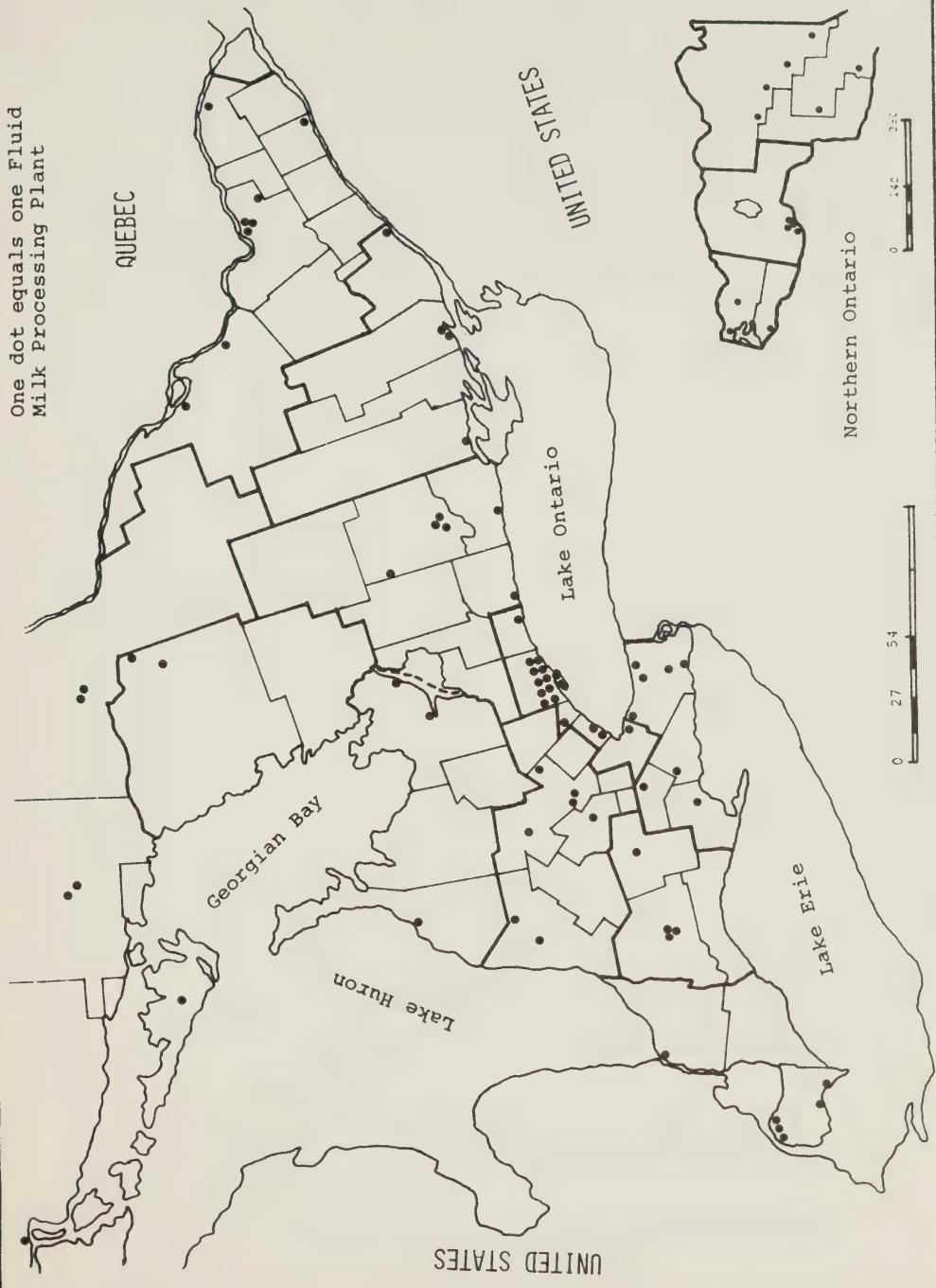


EXHIBIT 5

FLUID MILK SALES BY DISTRIBUTION AREA

<u>Distribution Area/District</u>	<u>1971</u>	<u>1975</u>
	<u>- thousands of quarts -</u>	
1	54,406	53,074
2	40,429	43,345
3	51,905	49,062
4	296,981	310,795
5	57,090	63,053
6	30,946	35,131
7	31,122	31,688
8	30,132	36,510
9	73,843	78,569
10	7,222	5,933
Kenora-Rainy River	5,803	6,171
Thunder Bay	14,892	15,848
Northern	42,120	44,051
Provincial Total:	736,892	773,231

Source: Ontario Ministry of Agriculture and Food.
Economics Branch. Annual Dairy Statistics

EXHIBIT 6

REFERENCES ON FLUID MILK PRICING¹

Bartlett, R.W. Are supermarkets charging consumers too much for handling milk. Illinois Agricultural Economics. pp.1-5. July 1973.

Bartlett, R.W. Fluid milk sales as related to demand elasticities. Journal of Dairy Science 47:1314-1326, 1964.

Bartlett, R.W. Milk distribution margins, prices and consumption : state-controlled versus competitive markets. Illinois Agricultural Economics. pp.17-26. July 1965.

Christensen, S.K. Chain stores and milk control; paper presented at the 29th annual meeting, International Association of Milk Control Agencies, Banff, Alberta, August 25, 1965 pp.65-78.

Cropp, R.A. and T.F. Graf. Milk programs of Wisconsin food chains. Research report 2423. Madison, University of Wisconsin. College of Agricultural and Life Sciences, September 1972. 20 p.

Food Prices Review Board. The consumption of bread and fluid milk in Canada, Ottawa, July 1975. 27 p.

Food Prices Review Board. Convenience food stores survey, Ottawa, November 1975. 19 p.

Food Prices Review Board. Dairy foods I : prices, Ottawa, December 1975. 34 p.

Food Prices Review Board. Food company profits and food prices, Ottawa, July 1974. 33 p.

Food Prices Review Board. Food company profits and food prices II, Ottawa, October 1975. 33 p.

Graf, T.F. Changing patterns in dairy marketing - grocery chain processing and distribution of dairy products; paper presented at the annual meeting of Dairy and Food Industries Supply Association, Naples, Florida, April 12, 1972. 12 p.

Groves, F.W. Vertical integration in the fluid milk industry; paper presented at the 31st annual meeting, International Association of Milk Control Agencies, Biloxi, Mississippi, October 24, 1967 pp.71-83.

Gruebele, J.W., S.W. Williams and R.F. Fallert. Impact of food chain procurement policies on the fluid milk processing industry. American Journal of Agricultural Economics 52:395-402, 1970.

Gruebele, J.W. Measures of efficiency in milk plant operations. Illinois Agricultural Economics. pp.38-43. July 1973.

¹ Prepared by Dr. Marvin Sundstrom, formerly Director of Research and Policy Development, The Milk Commission of Ontario.

EXHIBIT 6 ... continued

Jacobson, R. New developments in wholesale distribution; paper presented at the 32nd annual meeting, International Association of Milk Control Agencies, Milwaukee, Wisconsin, August 13, 1968 pp.76-84.

Knutson, R.D. Buyer strategy in bilateral oligopoly. American Journal of Agricultural Economics 50:1507-1511, 1968.

Manchester, A.C. The supermarket and milk distribution; paper presented at the 32nd annual meeting, International Association of Milk Control Agencies, Milwaukee, Wisconsin, August 13, 1968 pp.85-94.

Manchester, A.C. Market structure, institutions and performance in the fluid milk industry. Agricultural economic report 248. Washington, U.S. Dept. of Agriculture. Economic Research Service, January 1974. 40 p.

Manchester, A.C. The structure of fluid milk markets : two decades of change. Agricultural economic report 137. Washington, U.S. Dept. of Agriculture. Economic Research Service, July 1968. 51 p.

Manchester, A.C. Pricing milk and dairy products : Principles, practices and problems. Agricultural economic report 207. Washington, U.S. Dept. of Agriculture. Economic Research Service, June 1971. 60 p.

Parlby, G.B. Control of fluid milk prices in Western Canada 1932 - 1963. Edmonton, Alberta Department of Agriculture. Farm Economics Branch, 1965. 98 p.

Paulson, L.C. Uniform fair trade practice law; paper presented at the 29th annual meeting, International Association of Milk Control Agencies, Banff, Alberta, August 25, 1965 pp. 4-21.

Proceedings of a seminar in imperfections and possible solutions in the pricing and marketing of milk. Columbus, Ohio State University. Department of Agricultural Economics, March 1971. 143 p.

Reid, M.G. Consumer response to the relative price of store versus delivered milk. Journal of Political Economy. pp.180-186. April 1963.

Reschenthaler, G.B. The performance of selected independent regulatory commissions in Alberta, Saskatchewan and Manitoba; prepared for the Canadian Consumer Council, October 1972 pp.49-109.

Williams, S.W. The changing character of the fluid milk processing industry in Illinois. Illinois Agricultural Economics. pp.32-39. January 1965.

Wilson, L.E. Efficiency factors in store distribution of milk from a captive plant; papers in dairy marketing presented at the Agricultural Industries Forums, 1960 and 1961, University of Illinois. Department of Agricultural Economics, June 1961 pp.15-24.

EXHIBIT 7

SELECTED ANNOTATED REFERENCES¹

Allan, D. Concentration and competition in Ontario's fluid milk industry. Ontario Economic Review. pp. 3-14. November 1965.

This article is essential background reading for anyone concerned with the fluid milk industry in Ontario. The author focuses on the two themes of concentration and competition in Ontario and examines these themes in the industry over the 20 year period from 1945 to 1965. Before discussing these themes Allan provides background information on the structure and characteristics of the industry, its size and growth pattern, the nature of demand and the methods of distribution, the impact of technological change and the influence of government.

In dealing with the growing concentration in the industry, the author examined the history of mergers and the role of the "Big Three" in the industry. The "Big Three" consisting of Silverwood, Borden and Dominion Dairies controlled 35 to 40 percent of industry-wide sales by 1965. Furthermore, in each of the five major markets except Toronto the "Big Three" along with a single independent virtually overwhelmed other distributors. In the Toronto market four aggressive independents prevented the share of the "Big Three" from exceeding 60 percent. However, Allan indicated that the overall trend in the industry was towards greater concentration of sales in the hands of a few large firms.

The author noted that the revival of competition in the Ontario fluid milk industry was influenced by three underlying developments: the decontrol of prices which was recommended by Justice Wells in the Ontario Royal

¹Prepared by Dr. Marvin Sundstrom, formerly Director of Research and Policy Development, The Milk Commission of Ontario.

Commission on Milk Report, 1947, rapid technological advances, and extensive shifts in consumer demand as evidenced by new packages, new products and new methods of distribution. The author concluded that the overall impact of increased concentration on competition has been neutral.

In general the author felt that competition had been a dynamic and revitalizing force in the industry, resulting in new and better products and a wider choice to consumers.

Bartlett, R. W. Are supermarkets charging consumers too much for handling milk. Illinois Agricultural Economics. pp. 1-5. July 1973.

Results from a 1972 study of 46 markets showed that the estimated markup in supermarkets averaged 7.9 cents per quart or 41 percent. Furthermore, the supermarkets forced distributors to cut costs to the bone for processing, packaging and delivery of milk to stores. The author noted that average estimated markups in the 10 most efficient markets were four cents per quart as compared to 11.3 cents per quart for the ten least efficient markets. He also observed that markets under retail price control continue to have wider gross margins than competitive markets.

Bartlett, R. W. Fluid milk sales as related to demand elasticities. Journal of Dairy Science 47:1314-1326. 1964.

In a long run study (covering a year or more) of 55 markets in the United States the author related per capita consumption to price, income and non-white consumption. This study showed that in markets where the retail price was 20 cents per quart or over, the demand for milk was elastic. That is, a decrease in price was accompanied by an increase in milk consumption greater than the proportionate decrease in price. Since the lowest retail price in three out of

every four markets in the United States is over 20 cents, it is evident that a downward adjustment in price would be helpful to the dairy industry in increasing total milk consumption. It should be noted that the results from this long run study are opposite those of 16 earlier short run studies.

Bartlett, R. W. Milk distribution margins, prices and consumption : state-controlled versus competitive markets. Illinois Agricultural Economics. pp. 17-26. July 1965.

The author examined the impact of retail price controls for fluid milk in the United States from 1933 to the mid-1960's. Federal control of retail prices was discontinued after seven months because of rampant violations, under-the-counter deals, and the establishment of unnecessarily high retail prices and distribution margins. It was also noted that only 13 of the 29 states that controlled retail prices have retained that power. Bartlett also compares the situation in Ohio, where no retail price controls exist, with Pennsylvania where retail price controls exist. In Ohio, retail prices and distributor margins were lower, while producer prices and per capita consumption were higher. Bartlett noted that the adoption of new low-cost methods and techniques in milk distribution were introduced more quickly in the uncontrolled markets than in the state controlled markets.

Christensen, S. K. Chain stores and milk control; paper presented at the 29th annual meeting, International Association of Milk Control Agencies, Banff, Alberta, August 25, 1965 pp. 65-78.

In the United States retail price fixing has been an extremely important influence upon the integration of chain stores into the processing business. As resale prices generally have been set at levels which permit the average efficient operator to remain in business and to make a small

profit, large volume processors will make extremely good returns under such a pricing arrangement. Given good management, these prices make large well organized plants under such a setup rather profitable. In order to share the profits resulting from the high fixed margins set by control agencies, some chains have integrated into dairy processing. In other cases, retailers are giving strong consideration to integrating into processing because of the profit umbrella provided under price control.

Clark, J. H., R. G. Marshall and B. B. Perkins. Canadian dairy policy : a report to the Federal Task Force on Agriculture. Guelph, University of Guelph. Department of Agricultural Economics, 1969. 156 p.

This report consists of six chapters, the first two dealing with the structure and income problems of the primary sector and the impact of price policies on primary producers. Chapter three deals with the changing structure of the processing-distributing sector, while chapter four discusses the role of dairy product substitutes. The authors examine demand and supply relationships in chapter five and make projections on domestic disappearance, imports and exports. A discussion of alternative dairy industry policies concludes the report. The recommendation on marketing margins is of special relevance to this Inquiry: "Increased efficiency in processing and distribution of dairy products should be encouraged. Specifically, federal and provincial governments should not attempt to set margins for processors or distributors through administered pricing."

Cropp, R. A. and T. F. Graf. Milk programs of Wisconsin food chains. Research report 2423. Madison, University of Wisconsin. College of Agricultural and Life Sciences, September 1972. 20 p.

The Wisconsin Unfair Trade Practice Laws, which establish minimum retail and wholesale markups on milk, appear to have increased the market power of large chains. The two most important effects of these practices were to

limit price discounts and increase store profits on packaged milk. Price competition has lessened, and price and profits on packaged milk have been more stable and higher. Because of the efficiency and control exercised by large chains with their high volume, these chains appear to have benefitted the most from the "average costing" procedures.

Food Prices Review Board. The consumption of bread and fluid milk in Canada. Ottawa, July 1975. 27 p.

The consumption of bread and milk was little affected by observed changes in the incomes of consumers or in the prices of the products. In effect, the income elasticities for both commodities are estimated to be low. Consequently, the conclusion reached was that Canadians of all income levels are sufficiently committed to the consumption of these two foods that they appear to be little influenced by variations in the price of the products.

Food Prices Review Board. Food company profits and food prices. Ottawa, July 1974. 33 p.

This report uses four measures of performance to assess eight major groups in the food industry. The dairy products industry group was the only group of food processing companies studied by the Board to have achieved a rate of return on equity in 1973 lower than the 1964-1970 average for the industry (7.5 percent as compared to 7.6 percent over the 1964-1970 period). Furthermore, the rate of return on equity decreased from 1972 to 1973 despite a lower rate of taxation. On the positive side, the industry has managed to increase its ratio of sales to equity (turnover) over the decade from 3.2 in 1964 to 5.5 in 1973. The turnover improvement has been the mainstay of the dairy products industry over the last 10 years. Without this improvement the rates of return on equity likely would have been lower than five percent.

Graf, T. F. Changing patterns in dairy marketing - grocery chain processing and distribution of dairy products; paper presented at the annual meeting of the Dairy and Food Industries Supply Association, Naples, Florida, April 12, 1972. 12 p.

A large number of food chain dairy operations already exist in the United States and indications are that additional larger chains will either enter the field or expand their existing facilities. Food chains will expand their dairy plant operations because of advantages which include: (1) more uniform quality, (2) lower distribution costs, and (3) more efficient processing by producing for a large area in a high capacity automated plant. In addition, the advent of fair trade practice laws in various states has helped chains achieve higher profits. This has occurred because under these laws prices are set at levels to reflect average costs and the chain costs are generally lower than average.

Groves, F. W. Vertical integration in the fluid milk industry; paper presented at the 31st annual meeting, International Association of Milk Control Agencies, Biloxi, Mississippi, October 24, 1967. pp. 71-83.

Vertical integration refers to the combining of firms in two or more levels of the marketing system under the same management. The author makes two major points in his presentation: (1) the greatest long run potential of vertical integration may lie in control over the marketing channels rather than in short run processing profits and (2) the states in which pricing policies have been carried beyond the producer level were characterized by more integrated operations. Groves noted that those organizations controlling dairy marketing channels in the future will be in a powerful position to shape policy in the industry. Furthermore, establishing retail prices guarantees the margins of processors and makes integration more attractive.

Gruebele, J. W. Measures of efficiency in milk plant operations. Illinois Agricultural Economics. pp. 38-43. July 1973.

Due to competitive pressures resulting from the growth of food chains, the development of centralized milk programs and the trend towards vertical integration into milk processing by food chains, it will become necessary for milk processors to make adjustments if they are to survive. Data collected by a Dairy Management Information System over 19 months showed that labor productivity increased and per unit costs of labor decreased as plant volume increased and the number of items processed decreased. Labor productivity could also be increased by planning production more carefully (reducing daily variations in output per man hour), by adopting new technology, by effectively motivating plant personnel and by keeping improved records.

Gruebele, J. W., S. W. Williams and R. F. Fallert. Impact of food chain procurement policies on the fluid milk processing industry. American Journal of Agricultural Economics 52:395-402, 1970.

The growth of the food chains and the adoption of centralized milk programs, including the use of private label brands and their own processing facilities, has improved the bargaining position of food chains relative to fluid milk processors. As a result milk processors have been faced with a number of problems: (1) smaller profits on processing and distribution, (2) greater risk associated with the potential loss of a large volume individual account, (3) growing dependence on and control by food chains, (4) need to give discounts that are out of proportion to savings and (5) reduced effectiveness of processor brands. A number of adjustments have been made by fluid milk processors faced with these problems: (1) increase in size and automation to keep unit costs down, (2) establishment of dairy stores and convenience

markets, (3) diversification into non-dairy operations and (4) increased use of distributors to circumvent high labor costs.

Jacobson, R. New developments in wholesale distribution; paper presented at the 32nd annual meeting, International Association of Milk Control Agencies, Milwaukee, Wisconsin, August 13, 1968 pp. 76-84.

Because of the difference in cost per unit between store sales and home delivery, there has been a marked shift in volume of fluid milk sales from the retail to the wholesale level. Two significant implications of this dominance of store sales of milk can be found in the diminishing market power position of fluid milk processor-distributors and in the continuous erosion of processor margins. Faced with these pressures, the processors have attempted to reform home delivery in the retail area. On the wholesale side, the two major alternatives have been to integrate vertically into the retail area and to make efficiency, price and service adjustments in wholesale distribution methods. These new developments create new opposition to controls and present an increasingly complex series of problems for milk control agencies.

Knutson, R. D. Buyer strategy in bilateral oligopoly.
American Journal of Agricultural Economics
50:1507-1511, 1968.

Knutson based this article on a market structure case study in five Minnesota fluid milk markets. Two major considerations dominated the buyer's strategy: (1) to obtain a uniform and acceptable quality product at a price consistent with processor costs and (2) not to pay a higher price than competitors. With these considerations in mind the retailers were found to be using five main strategies in their negotiations with milk processors: (1) they made options with actual offers of lower prices, (2) they made options by bluffing offers of lower prices, (3) they transferred processors, (4) they concentrated milk purchases and (5) they threatened to integrate vertically.

Manchester, A. C. The supermarket and milk distribution; paper presented at the 32nd annual meeting, International Association of Milk Control Agencies, Milwaukee, Wisconsin, August 13, 1968 pp. 85-94.

The author examines the changing relationship between retailers and processors which has developed over the previous 30 years. Factors which have affected this relationship are the growth of supermarkets, their use of private labels, the decline in home delivery, the greater variety of outlets and the loss of major outlets by processors. In addition, Manchester reviews three studies of gross margins of processors and retailers in selected American cities. It was noted that gross margins have been increasing in supermarkets over the past decade. As a percent of sales for chain stores in 1965 a gross margin of 19 percent was cited. In conclusion, the author notes that "a goal of setting prices at levels which will permit everyone who is presently in the milk business - farmer, processor, and distributor - to stay in is not feasible. There is no price structure which will allow margins that high and, at the same time, not set up intolerable strains."

Parlby, G. B. Control of fluid milk prices in Western Canada 1932-1963. Edmonton, Alberta Department of Agriculture. Farm Economics Branch, 1965. 98 p.

Following a discussion of the factors giving rise to the introduction of controls over fluid milk pricing, Parlby undertakes a comparison of milk control legislation in the four Western Provinces. A detailed examination of the mechanics of their milk pricing and an historical comparison of producer price movements comprises chapters three and four. The author concludes the study with a comparison of the objectives, philosophies and accomplishments of the Western Canadian milk control boards.

Ontario. Milk Industry Inquiry Committee Report.

Chairman: S. G. Hennessey. Toronto, Queen's Printer, 1965. 330 p.

A broad mandate was given to this Committee to examine issues and problems in all sectors of the industry, and to make recommendations for a new milk marketing plan for Ontario. Recommendations arising from this Inquiry have been instrumental in shaping the Ontario dairy industry over the past 10 years. Specifically, the formation of The Milk Commission of Ontario and The Ontario Milk Marketing Board came about as a result of the Inquiry. With respect to pricing, two recommendations were made: (1) that formula pricing which had been in effect since 1954 be discontinued and (2) that flexibility in pricing be adopted in order to promote new ideas and to encourage innovation.

Ontario. Royal Commission on Milk Report, 1947.

Chairman: Dalton C. Wells. Toronto, King's Printer, 1947. 205 p.

This Commission was granted broad powers to inquire into costs, prices, price spreads, trade practices, methods of financing, management, grading policies and other related matters among producers, processors and distributors. The most significant recommendation for the current Inquiry was the recommendation respecting price fixing at the consumer level: "The price of fluid milk at the consumer level be not agreed to or fixed in ordinary circumstances. The power should be a corrective one only" Within four years of this report the last vestige of retail price control for fluid milk in Ontario was removed.

Reschenthaler, G. B. The performance of selected independent regulatory commissions in Alberta, Saskatchewan and Manitoba; prepared for the Canadian Consumer Council, October 1972. pp. 49-109.

The author undertakes a detailed study of the role and function of price control of milk in Alberta and then

compares the Saskatchewan and Manitoba situations to Alberta. Reschenthaler concludes the study with a critical evaluation of the role of milk control boards in the Prairie Provinces. He notes that the consumer is the big loser under the present system. The regulatory authorities do not possess reliable indexes of economic performance for producers, processors or distributors, nor have they seriously attempted to establish any such indexes. As a result the producers,¹ processors and distributors are simply requesting an "about right" price increase every one or two years. The authorities grant some increases and the public assumes the increases are fair. In effect, the standards for determining fairness are not clearly defined. As an alternative the author suggests that consideration be given to returning to the competitive free enterprise market mechanism for determining retail milk prices.

Williams, S. W. The changing character of the fluid milk processing industry in Illinois. Illinois Agricultural Economics. pp. 32-39. January 1965.

A number of major changes had occurred in the fluid milk processing industry in Illinois over the previous 15 years. These changes include a sharp decline in number of plants, an increase in the average size of plant, and a widening of the distribution areas. Comparison with areas outside the state indicated these trends were national in scope. Results from this study along with cost studies indicate that plants in the largest volume group have a strong competitive advantage over smaller plants. Much of this competitive advantage of larger plants was derived from a widening of the distribution areas for packaged milk products.

¹ Since this report was published the producers in Alberta have introduced a cost of production formula as a guide to their pricing decisions.

Williams, S. W. and D. A. Vose. Extent and significance of private-label brands of ice cream and milk. Journal of Dairy Science 49:418-419, 1966.

The extensive use of private-label brands indicates that food chains are in a strong bargaining position when they negotiate with processors of milk and ice cream. This strength results from the food chains' control of their counter space and their marketing power as large-scale buyers. Not only can food chains determine which brands they will stock but they can merchandise their own brand at lower prices and with a minimum of advertising and promotion expense. Furthermore, with the increased use of private-label brands, consumers become less aware of dairy company brands. Thus, it can be concluded that food retailers have a substantial influence on processing operations even when they do not own the facilities.

Williams, S. W. et al, Organization and competition in the Midwest dairy industries. Ames, Iowa State University Press, 1970. 339 p.

This book provides a comprehensive regional treatment of a broad set of problems facing the dairy industry in the United States Midwest. The organization of material represents a compromise between a commodity and a structural approach. Chapter four is of special interest as it deals with the "Fluid Milk and Ice Cream Industries." The first part of the chapter provides a description of the market organization and structure of the industry while the second part examines conduct in the fluid milk and ice cream markets. Topics covered in the latter part of the chapter include price fixing and market sharing agreements, price leadership, price competition, the relationship between structure and price competition, hidden price competition, price discrimination and implicit price competition and non-price competition. This book provides some excellent insights into the nature of the dairy industry in the United States Midwest.

Wilson, L. E. Efficiency factors in store distribution of milk from a 'captive' plant; papers in dairy marketing presented at the Agricultural Industries Forums, 1960 and 1961, University of Illinois. Department of Agricultural Economics, June 1961 pp. 15-24.

The objective of this study was to account for the reasons why a captive plant (integrated processing-retailing operation) could deliver milk to stores at less than one-third of the average cost of conventional wholesale delivery and one-sixth of the average cost of conventional retail delivery. Five factors were cited for these cost differences: (1) small number of products, (2) large volume of milk delivered per route, (3) large volume of milk delivered to each store, (4) central location of plant and low route mileage and (5) efficient use of route labor.

Wright, R. W. and R. L. Mansell. The regulation of distributor prices for fluid milk in Alberta. Alberta Department of Consumer Affairs report prepared for presentation to the Public Utilities Board at its public hearings in October 1975.

The purpose of this report was to examine and evaluate the alternatives to the retail price setting policy for fluid milk in Alberta. At present minimum retail prices are established for both store and home delivery with no differential between them. Although consideration was given to the policy of having no retail price regulation, major emphasis was on policy changes involving a modification of the present system.

EXHIBIT 8

IMPLICATIONS OF COSTING THE
RAW MILK CONTENT OF FLUID MILK PRODUCTS ¹

The purpose of this exhibit is to show how various acceptable costing methods might be applied at the processor level in the milk processing industry to calculate the cost of the raw milk content of fluid milk products. But first it is necessary to understand some of the basic issues of cost accounting and how raw milk is converted into fluid milk or other products.

Cost accounting:

Cost accounting has three basic objectives: to determine the costs that are properly assignable to products sold or still in inventory, to provide controls for measuring efficiency, and to provide figures for management decisions. But the costing information that is generated has potential limitations, and the users of the data must be aware of them and the effect they may have. The potential limitations are to a large extent caused by assumptions in the cost accounting process. There are various established costing practices; while any one of them may be more appropriate than another in the specific circumstances, there is no one "correct" method of cost determination. No two cost-finding procedures are identical, and no two procedures will produce continuously identical results. The most important consideration is that the method selected be the one most appropriate in the circumstances and that it be applied consistently.

Raw milk processing:

Cost accounting for milk processors reflects the nature of the process of converting raw milk into fluid milk and other products. The conversion process consists of taking raw milk that contains a certain level of butterfat and, through a separation process, converting it into other products

¹Prepared by Price Waterhouse & Co.

with different and lower butterfat levels. Thus the raw milk is a common product from which other products are derived, and up to the point of separation all costs incurred are "common costs" that have to be allocated to the end products. The selection of one of the equally acceptable bases of allocation is much more arbitrary than the determination of the elements which are common costs. In fact the basis of allocation used may be heavily influenced by the company's business objectives rather than by theoretical costing considerations.

The separation process creates a residual product in the form of cream with a high butterfat content (about 40%). This cream can be remixed with low butterfat content milk and sold as fluid cream or be used in the manufacture of other products, such as ice cream or butter. As some milk processors also manufacture these products the value assigned to the surplus cream has costing implications.

Cost of raw milk:

Raw milk is purchased from the Ontario Milk Marketing Board (OMMB). The amount paid, which as explained later may not be the same as "cost" for costing purposes, is based on the quantity and use of the products derived from it. These products are categorized into classes for which there are prescribed OMMB prices that have been set to recognize the ultimate use of the product. In the conversion and packaging process some of the product will be lost in the normal course of processing and some will be lost because of production difficulties. This loss of product called "shrinkage", if less than 2% of gross purchases, will be paid for at a lower price.

The prices for each class of product are related to a standard butterfat content of 3.5% in the raw milk. If the actual butterfat content of the raw milk differs from this standard, then the prices are adjusted accordingly. In June 1975, this adjustment was 13¢ for each 1/10 of 1% variation from the standard 3.5%.

To illustrate the above, the following is a simplified calculation of the amount to be paid to the OMMB. The prices shown are those in effect in June 1975 for a processor located in Southern Ontario who received raw milk with the standard butterfat content of 3.5%. The quantities for each class are based on theoretical conversions that have been adjusted for shrinkage, and then rounded for simplicity. The quantities for homo, 2% and skim are arbitrary amounts based on industry sales, and the butterfat content is based on standard percentages.

	Quantity of raw milk purchased (in cwt.)	Price paid Per cwt.	Total
Class 1-			
Homo (3.25% butterfat content)	50,000		
2% (2.00% butterfat content)	40,000		
Skin (0.01% butterfat content)	4,000		
	<u>94,000</u>	\$12.01	\$1,128,940
Surplus cream (Class 3)-			
Fluid cream used in ice cream (approximately 40.00% butter- fat content)	2,000	8.85	17,700
Shrinkage penalty-			
Class 5 - up to 2%	2,000	8.21	16,420
Class 1 - over 2%	2,000	12.01	24,020
	<u>4,000</u>		<u>40,440</u>
Quantity of raw milk purchased	<u>100,000</u>		
Amount payable to OMMB			<u>\$1,187,080</u>

The first step in the costing process is to determine the "cost" of the Class 1 products, and then to allocate it to the quantities of homo, 2% and skim. In determining what outlays are considered to constitute the total cost of these products, consideration has to be given to the surplus cream and the shrinkage penalty.

Surplus cream-

Cream that is surplus to the production of fluid milk products constitutes a by-product for costing purposes. The normal treatment of by-products is to ignore their cost (which might not be identifiable in any case) and to record any proceeds received from their disposal as a reduction of the cost of the main product or as miscellaneous income.

In the milk processing industry, surplus cream has a high butterfat content and while there is normally a market for the surplus cream, at certain times of the year processors may be unable to sell it and are faced with a choice of dumping it or increasing the butterfat content of fluid milk products to the maximum permissible level. Some processors also make ice cream or butter for which the cream is an essential ingredient. In the latter situation, the processor would transfer the cream from his fluid milk cost centre to his ice cream manufacturing cost centre. For costing purposes he needs to establish a transfer price, and his decision as to the appropriate transfer price may be heavily influenced by the company's business objectives, rather than by theoretical costing considerations alone.

Shrinkage penalty-

Overall, the level of shrinkage in the industry is so low that its treatment for costing purposes will not significantly affect the unit cost of the fluid milk products. Its treatment may depend on the assumptions about the cause of the shrinkage. It might be considered to be wastage, in which case it could be treated as a processing cost and charged as a processing expense, either as a general processing expense of all products or as processing expense of a particular product if it can be identified with that product as in spillage during the filling process. Alternatively, it could be treated as an increase in raw material cost, in which case it would be assigned to Class 1 products either as a general or a specific cost, depending on whether it can be identified with a product.

Allocation of cost of raw milk:

The main element that will significantly affect the cost of the raw milk attributable to homo, 2% and skim will be the method of allocation used.

It must be emphasized again that there is no one correct method for doing this, since common costs by their nature cannot be identified with end products.

A method must be selected that is reasonable in the circumstances. The first, and perhaps the method most in accord with the simple mechanics of the separation process would be to consider that each product should bear the same unit cost. That is, the cost of homo would be the same as that of 2% and skim.

The industry does not consider this method acceptable because it gives no recognition of "value" which can be related to the butterfat content.

For the milk processing industry, acceptable methods of allocation are those based on the relative market value of the fluid milk products and on the value of the butterfat content.

Relative market value-

The assumption in the relative market value approach is that each product should contribute equally to total gross profit as far as common costs are concerned. The only difference in the actual gross profits between products would be because of costs which are incurred after the separation process and are therefore specifically identifiable with a product.

On the relative market value basis, and using the figures in the above example, common costs would be allocated on a percentage basis as follows:

	Processor				Percentage
	Quantity		selling price	Total	
	Cwts.	Quarts	per quart		
Homo	50,000	1,938,000	33¢	\$ 639,540	54%
2%	40,000	1,550,400	32	496,128	42
Skim	4,000	155,040	30	46,512	4
	94,000	3,643,440		\$1,182,180	100%
	<hr/>	<hr/>		<hr/>	<hr/>

Notes:

1. Quart equivalents are based on the standard conversion of 1 cwt. to 38.76 quarts.
2. The processor selling price per quart is based on 1¢ or 2¢ retail selling price differentials between the three products, less a deduction for costs incurred beyond the separation stage.

Butterfat value-

Costing on the basis of butterfat value is related to the value of the butterfat in raw milk. For example, in June 1975 the cost of raw milk containing 3.5% butterfat used in fluid milk products was \$12.01 per cwt. and the adjustment for each 1/10 of 1% difference was 13¢. On this basis, and before any adjustment for shrinkage and surplus cream, the cost of butterfat-free milk would be \$7.46 as shown below.

Cost of raw milk, per cwt.	\$12.01
Less: Butterfat-	
3.5% at 13¢ for each 1/10 of 1%	<u>4.55</u>
Cost of butterfat-free milk, per cwt.	<u>\$ 7.46</u>

Thus the cost of the raw milk content for homo, 2% and skim would be calculated as follows:

	Content in lbs.	Cost per cwt. Per lb.	Total
<u>Homo-</u>			
Butterfat	3.25	1.3000	\$ 4.22
Butterfat-free milk	<u>96.75</u>	<u>0.0746</u>	<u>7.22</u>
	<u>100.00</u>		<u>\$11.44</u>
<u>2%-</u>			
Butterfat	2.00	1.3000	\$ 2.60
Butterfat-free milk	<u>98.00</u>	<u>0.0746</u>	<u>7.31</u>
	<u>100.00</u>		<u>\$ 9.91</u>
<u>Skim-</u>			
Butterfat	.01	1.3000	\$.01
Butterfat-free milk	<u>99.99</u>	<u>0.0746</u>	<u>7.46</u>
	<u>100.00</u>		<u>\$ 7.47</u>

This method will not permit an allocation of the total cost as in the relative market value method, but rather will produce imputed or theoretical costs that will not agree with the accounting records. This is not an insurmountable problem, however, and in fact the imputed cost approach is quite commonly used by commercial enterprises as being the most practicable method of calculating costs.

Summary:

Responses to questionnaires by processors indicated the prevalent practice used is to determine the cost of the raw milk content of fluid milk products on an imputed basis, using the butterfat value concept as a broad guide. Actual methods used in applying this concept varied considerably, and in the main consisted of rather simplistic approaches. That this is done in practice tends to support the theoretical costing argument that in a common cost situation, costs computed for individual products have little influence on pricing decisions. Rather, emphasis is placed on establishing selling prices which will enable all the products produced to be sold.

EXHIBIT 9

PRICING STRATEGY¹

The arbitrariness of cost allocations to individual fluid milk products reinforces the general observation of economic analysts that product pricing strategy is only loosely related to individual product costs. The organization charts of most companies indicate this by their separation at the vice-presidential level of responsibilities for marketing and production. The marketing vice-president's attention is directed to revenue maximization, while that of the production vice-president is focused on cost reduction. Before examining specific pricing strategy concerns in the fluid milk industry, two examples are provided to illustrate this division of functions and its implications for fluid milk processors and retailers. These examples may not exactly reflect the practices of a particular operator, but they have a sound theoretical and practical basis.

Processor operating emphasis:

The statement shown below is a simplified income statement for a processor. It highlights those aspects of his operations requiring emphasis, if he is to remain profitable.

INCOME STATEMENT OF A
PROCESSOR OF FLUID MILK PRODUCTS

	<u>Quarts</u> (^{'000's})	<u>Average per quart</u>	<u>Total</u> (^{'000's})
Sales:			
Homo	12,861	.330¢	\$ 4,243
2%	21,698	.320	6,938
Skim	2,830	.298	843
Other fluid milk products	<u>2,696</u>	<u>.813</u>	<u>2,192</u>
	<u>40,085</u>	<u>.355</u>	<u>14,216</u>
Operating costs:			
Raw milk	.217	8,687	
Labour	.036	1,452	
Containers	.010	382	
All other costs and expenses	<u>.062</u>	<u>2,474</u>	
	<u>.325</u>	<u>12,995</u>	
Profit before taxes	<u>.030¢</u>	<u>\$ 1,221</u>	

¹ Prepared by Price Waterhouse & Co.

In addition to total product sales, the statement also shows the quantities of each fluid milk product sold in terms of quarts, and the average revenue per quart sold. The figures in the statement are derived from information provided to the study by a number of processors. The amounts shown have a typical relationship to each other, although their absolute values are altered to preserve the anonymity of respondents.

Operating costs include the three main operating expenses, raw milk, labour and containers, and a "catch-all" caption for all other costs and expenses. These are the categories used in examining processor costs in this report, and the three identified costs are the most important to control.

The difference between total sales and total operating costs is profit before taxes. Income taxes would be deducted from this figure to arrive at the net profit from operations. The income tax levied on the profit will vary from company to company, ranging upward from about 42% to about 50% of profit before taxes. Because of these variations, operating attention is directed only to profit before taxes, while tax management is left to financial strategists.

It is apparent from the statement that marketers will seek to maximize total sales. They may do so by increasing the number of quarts sold at a constant average sales value. Thus, when prices are stable, a processor can increase revenue by adding to his number of customers, so that he sells more quarts of product without any substantial relative change in the proportion of sales of each product. Or they can increase total sales by increasing the average return on the same number of quarts sold. One way of increasing the average return on a constant number of total quarts is to change the pattern of sales so that more of a higher valued product is sold, while sales of a lower valued product are reduced.

Thus, the processor has three main variables which he can attempt to manipulate - sales quantities, product mix and product price. Change in any of these variables occurs only slowly, because every attempt to alter market share or price is met by a competitive reaction. Both competitors and customers will prefer stability in the marketplace and will seek to restore historic equilibrium. Pricing strategy is therefore able to operate only within a limited range. Nevertheless, its objective is totally oriented to maximizing revenue from all sales.

Production strategy is focused on cost reduction. Production executives in the same processor's operation may come into conflict with marketing executives when marketing strategy results in changes in production requirements that increase total production costs. This is so because their attention is directed to controlling average dollar costs per quart of production. Their effectiveness as managers will be judged on their skill in managing these performance indicators.

This conflict between marketing and production objectives is resolved only at the chief executive level. Only he can decide whether a particular marketing program will provide more revenue than the cost it entails. In this role he must often mediate disputes between marketing and production executives. In effecting a compromise that is acceptable to both, he also tends to perpetuate equilibrium and to reject suggestions which would be seriously disruptive in the marketplace or in his company.

Retailer operating emphasis:

A retailer's operating emphasis has the same basic dual structure, emphasizing marketing on the one hand and expense control on the other. The following statement, which is derived from respondents' statistics, shows those matters to which the retailer gives most of his attention.

INCOME STATEMENT OF RETAILER

	<u>Grocery</u>	<u>Produce</u>	<u>Meat</u>	<u>Total</u>
Departmental square footage	<u>14,300</u>	<u>3,600</u>	<u>1,300</u>	<u>19,200</u>
Sales ('000's) (Per square foot)	\$2,206 (154)	296 (82)	752 (578)	3,254 (169)
Cost of sales	<u>1,787</u>	<u>196</u>	<u>595</u>	<u>2,578</u>
Gross profit	\$ 419	100	157	676
(Percentage to sales)	<u>(19.0%)</u>	<u>(3.4%)</u>	<u>(20.9%)</u>	<u>(20.8%)</u>
Operating costs:				
Labour				287
Space				143
All other expenses				176
				606
Profit before taxes			\$ 70	<u> </u>

The attention of his marketing executives is focused on gross profit rather than on total sales revenue, as was the case of the processor. This is because there is no doubt as to the cost of the merchandise he is selling. It can be specifically matched with selling prices of any of the products on his shelves. He will negotiate with his suppliers to minimize his cost of each product, and he will seek to set the highest selling price which his customers will accept.

Specific purchasing and pricing decisions in large stores are left to specialists in these functions. The marketing executive judges their performance on the basis of comprehensive statistics. Thus the marketing activities of a typical chain of stores are divided into three departments - grocery, which generally includes fluid milk products, produce and meat. The key indicators of performance in these three areas are the percentage of gross profit and turnover.

The revenue section of the retailer's income statement therefore emphasizes square footage, sales dollars per square foot, sales, cost of sales, gross profit and the percentage of gross profit to sales. It is possible for any department to alter square footage only after negotiation with the other departments in a large store. The sales dollars per square foot of a department's space will change only slightly to reflect inflation and the attractiveness of particular commodities. But growth of this performance measurement is limited by the fact that consumers in the particular operating district of a store can eat only so much and use only so many household products. Changes in sales volume will reflect these constraints. Cost of sales will be determined by the negotiating power of the store with its suppliers and will also tend to change only slowly as this purchasing power reflects the retailer's increasing or decreasing importance to his suppliers. Gross profit is the result of all of these variables and its percentage to sales is the basic measurement of each department's merchandising effectiveness. Typically, pricing of individual products seeks to obtain the same average percentage of gross profit to sales price in each department. Thus, when a product is priced, the mark-up over cost is at the average mark-up for the department unless competitive conditions permit a premium or force a reduction from this average.

Turnover is a function of the square footage of store space devoted to each of the three departments divided into the total sales of those departments. Improvements in this ratio indicate more intensive use of space. As long as the selling price of an item is greater than its cost, no matter by how little, it is to a store's advantage to increase that item's sales volume. It does not pay to increase the turnover of a single product if that can be accomplished only by increasing its share of departmental space at the expense of other products with higher turnover, unless the difference in their gross profits compensates for this action.

The principal operating expenses relate to overall store operations. In the largest stores some labour may be specifically identifiable with the operations of a particular department. More often, employees float from area to area depending on shelf stocking needs, checkout counter line-ups and other employees' absences.

While space is allocated to departments for turnover calculations in the operating revenue section of the income statement, space costs are controlled as a whole. Rental costs have to be negotiated with owners who have no interest in the use of any sub-section of their property. Lighting has to be effective throughout the store. Property taxes apply uniformly to the whole store's operations.

Thus, the layout of store premises for effective merchandising is a separate consideration from the minimization of store expenses. Only when consideration must be given to possible expansion of a store will marginal calculations be undertaken to determine whether the additional space can be profitably employed.

Part II of this report deals with these cost aspects. The remainder of this appendix examines the means available to processors and retailers to improve operating revenues. Three general considerations dominate marketers' planning - share of market, sales mix and sales price.

Share of market:

Share of market considerations are limited by the organizational characteristics of the marketer and by the extent of his marketing area. A chain store will

compare its share of market with those of other chain stores serving the same regional or national markets. A corner store will judge its share of market in relation to those of other stores across the street or in the same block. In a fully competitive situation, share of market tends to be stable over a long period. One competitor's efforts to expand his share of market will be almost immediately matched by equal or greater efforts of others in the market area.

Thus, price reductions in a high profile product such as milk demand competitor response. A competitor may equal the aggressor's price reduction or may compete more strongly by offering even lower prices. Escalation of such activity leads to price wars in which products are sold at less than their cost price. These "loss leaders" become a strong signal to the buying public who will start to shop for the lowest price. Then, for a short period buying patterns will be disrupted as store loyalties disappear. However, in time, price war activity wears itself out and traditional patterns of buying quickly re-establish themselves.

The losses retailers suffer from price wars in particular products have to be made up in the sale of other products or in later price increases in that product. Knowledgeable retailers budget for a certain amount of price war activity and their effect is thus diffused throughout the whole pricing structure. The effect on any one product will be almost negligible, because the amount of price war losses to be recovered from sales of other products is such a small proportion of total gross revenues of the store.

Occasionally suppliers will provide limited assistance to stores caught in price wars. They may reduce their selling prices of the particular product to limit the retailer's loss of gross profit. However, suppliers prefer stability in the marketplace, because price wars involve costly administrative adjustments and demand a great deal more attention from sales representatives. Thus they will usually be unwilling to offer any support which might be interpreted as encouragement of the price war.

Competition of this kind can occur also in the area of service. In general, it is to the advantage of suppliers and retailers to minimize their costs. However, from time to time they may incur additional costs to introduce a service which

they feel will differentiate them from their competitors and attract customers. However, the speed of change will be much less than that in price wars. Even then, only so much additional cost can be tolerated before all the competitors look at their own and their competitors' activity and decide to call a halt. Over a reasonably short period of time service will then probably decline to its original level.

Institutional advertising is another way of attracting a greater share of market although its value is frequently questioned by marketing analysts. A minimum level appears to constitute "good citizenship". It supports trade magazines and maintains the image of a thriving organization. However, management is unlikely to consider institutional advertising of much real sales value.

Almost the only really effective way of altering share of market is through the sale and acquisition of companies or proprietorships in the industry. The acquisition of direct competitors - the purchase of one store by another, possibly followed by its closing - is called horizontal integration. The acquisition of a distributorship or retailer by a processor is called vertical integration. It results in the acquirer adding to his list of customers those directly served by the other link in the chain.

Integration also has its limits. Undue concentration of an industry is contrary to the public interest and laws exist to prevent it. Even without these laws, the quasi-monopolistic profits of an acquiring organization will be an incentive to small competitors to share in them.

Sales mix:

Actions to improve sales mix to sell a greater volume of high margin items include advertising, packaging and display.

Handbills are the most familiar form of advertising to customers of local retail stores. Handbills will present both loss leader and high margin items. The retailer's hope is that in purchasing the one, the buyer may also be attracted to the other. Newspapers and other media carry similar messages to larger audiences. Milk often appears in the advertising of certain classes of retailers.

The prolonged program to persuade consumers of the value of lower fat products has been of greater long run significance to the sales mix in the fluid milk market. Such a shift has probably had little effect on the profits of processors who gain a greater price for 2% and skim but have to lower the price of homo. The value of the resulting surplus butterfat may provide an incentive to this shift, but examination of industrial milk product margins is outside the scope of this study.

Packaging and display are direct means of attracting customer attention to high margin items. A well packaged product poorly displayed or an ugly package well displayed are equally ineffective means of influencing sales mix. Both processor and retailer must collaborate to gain the greatest advantage from improved packaging and display.

Sales price:

Planning to improve the sales price of particular products must take account of both competition and customer attitudes. Price increases may be impossible in a highly competitive market or where customers have no tolerance for price increases.

To some extent, competition is affected by the presence of "price leaders". These are firms in an industry whose dominance in the market allows them to experiment with price increases without fear of serious loss of sales. If these experiments do not meet with customer resistance, competitors will follow with equivalent price increases. In the fluid milk industry, a jug milk or convenience store may be a price leader in one region, while a chain store can be price leader in another.

Experiments in price leadership are always risky. A competitor may gain a significant volume of customers from the apparent "leader", if he does not increase his price by the same amount. Such a reaction may force the leader to withdraw to a more generally agreeable price level.

Customer resistance is also a key factor. In some products small price changes will have a large influence on the volume which customers will buy. In other products the demand seems almost constant no matter how wide the price variation.

In the former case, the product is said to have greater elasticity than in the latter. Elasticity is affected by the degree to which the product is an essential to normal living and by the extent to which there are alternative products. Fluid milk products appear to be essential, but for certain people too high a rise in the price of milk may make other drinks an alternative. In spite of much government support, the idea that powdered milk is an alternative to fluid milk has not gained consumer acceptance and powdered milk prices reflect this relative lack of demand. As a whole, fluid milk products may have relatively stable sales even though they have changing average prices. However, there may be rather rapid shifts in consumer preference for particular fluid milk products in response to price increases and decreases.

Role of the consumer:

This interplay between marketer and consumer is often analyzed using the analogy of voting behaviour. A firm offers a product for sale and consumers either vote for it or for other products when they make their purchases. Many votes indicate a higher assessment of value relative to competing products. A popular product can carry a higher price if it has more public support. An unpopular product will have to be sold very cheaply for it to obtain any position of influence in the market.

This analogy highlights the relativity of pricing strategy. In the long run, the marketer must maintain an adequate net profit or he will go out of business. He must seek to gain adequate support for all of his product lines in order to be able to charge prices which will cover his costs. But consumer loyalties are fickle, and he will need to adjust his individual product prices continually to maintain adequate revenues. There is no mechanical process for setting prices in relation to individual product costs.

In the fluid milk industry, the voting analogy appears particularly apt. Fluid milk products are purchased frequently, often daily, by those consumers who use them. The short life of the product means that retailers, distributors and processors are soon aware of changing customer preferences and can adjust their

prices to counteract or encourage apparent trends. But these adjustments can fail to generate the expected response.

In this dynamic environment, a consumer has an unmistakable influence on the pricing of individual milk products. The resulting averages displayed in this study are therefore the result of the process of daily negotiation between buyer and seller on the value of this important commodity.

EXHIBIT 10

FILL TOLERANCES FOR
BEVERAGE MILK PRODUCTS¹

In the early years of the fluid milk industry, most milk for household consumption was packaged in glass. In the manufacture of glass it was impossible to fabricate every container to an exact volume, thus the Federal Government established official allowances for under-capacity and over-capacity in a given lot. In principle, the Government recognized that 50 percent of the containers would be oversized and 50 percent undersized. To protect the consumer further, a lower limit of undersize was also established. The temperature at which capacity was determined was room temperature (68° F or 20° C.).

Deliveries of containers by the manufacturer were checked by processing plants as well as by the Government to ensure that the lot of containers was within the prescribed standards. In that glass containers were returnable, they were washed and refilled many times. There was no need to check the containers for package volume on a daily basis since the container determined the volume of fill. Furthermore, consumers could inspect each container at the point of purchase to ensure that the container was filled to a level slightly below the cap seat. The slight amount of air space in the bottle allowed for the expansion and contraction of milk due to changes in temperature.

At present, very little milk is sold in returnable glass. A three quart plastic jug has entered the market in recent years. Capacities of plastic jugs can be determined prior to purchase by the processor in the same manner as returnable glass containers. Like glass, the level of fill is visible to the consumer, thus short fill has not been of major concern to consumers.

¹Prepared by Dr. J. A. Meiser, Commodity Leader, Dairy, Ontario Ministry of Agriculture and Food.

In the past decades, more and more milk is reaching the consumer in paper cartons and plastic pouches. Unlike returnable glass and plastic 3 quart jugs, the volume of fill for paper cartons and plastic pouches must be a volume determined not by the container, but by the mechanism used to fill the container. In the case of paper, the fill point is not visible to the consumer and the air space in the carton greatly exceeds that of glass leaving the consumer with the impression that the carton is underfilled. In the case of plastic pouches, the product is visible, but there is no way of the consumer judging the product volume due to the container's lack of rigidity. Like paper, considerable air space must appear in plastic pouches to reduce the chance of rupture.

Because of escalating food prices, consumers are becoming more concerned about pricing and package volume. As a result, they have reverted to the only means of measurement available to them in the home, namely, pouring the contents of the package into household measuring cups or empty milk bottles. This is not a scientific method of determining capacity because:

- 1) cups and bottles are not calibrated to exact volumes at precise temperatures
- 2) volume of fill by Federal Regulation is at room temperature (68° F or 20° C), whereas the product is packaged and held at refrigeration temperature (under 40° F or approximately 4° C).

Recognizing the problems created by paper cartons and plastic pouches, the Federal Department of Consumer and Corporate Affairs enacted the Consumer Packaging and Labelling Act which establishes for all consumer packages:

- 1) representative and proper sampling procedures

- 2) tolerances for fill
- 3) allowances for defective packages.

Unfortunately, fill tolerances for beverage milk products are by volume and not by weight. There is no practical method of applying this regulation on the high speed packaging lines used throughout the fluid milk industry since the packages coming off the filler must be:

- 1) opened and the contents poured into a volumetric flask
- 2) drained into the volumetric flask
- 3) warmed to 20° C
- 4) adjusted for net weight because the product does not drain completely from the package.

The procedure as outlined by the Department of Consumer and Corporate Affairs is so impractical that hundreds of packages would have passed from the filler to the refrigerated storage area before adjustments could be made. Shutting down a filler line until volume measurements could be determined on a representative group of packages would materially increase the cost of the product to the consumer.

In that the butterfat content of beverage milk products is also specified by federal and provincial regulations, the weight per unit volume of consumer packages is relatively constant. Therefore, the Province of Ontario has submitted research data from the University of Guelph to the Consumer and Corporate Affairs Department of the Federal Government recommending that fill control of beverage milk products be by weight rather than volume. By utilizing weights, filling operations in plants could be monitored daily within each plant at relatively low cost and at a frequency that would ensure that consumers would be purchasing packaged dairy products that met federal regulations at all times.

Since the Federal regulation utilizes a statistical evaluation technique unfamiliar to all plant employees, it is imperative that responsible personnel be enrolled in specialized training courses. A five-day training session is now being offered by the University of Guelph twice each year.

In that specialized courses cannot be designed to accommodate the specific needs of individual plants, the Milk Industry Branch of the Ontario Ministry of Agriculture and Food has trained members of its staff in the principles of in-plant package fill control. Ministry personnel will visit plants on a regular basis to assist plant personnel in initiating and maintaining control programs. This is in addition to the regular enforcement program of the Federal Department of Consumer and Corporate Affairs.

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